DISTRESSED SUBSIDIZED HOUSING:
EFFECTS, PREVENTIONS AND SOLUTIONS

by

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ABSTRACT

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Submitted to the Department of Urban Studies and Planning on May 7, 1976, in partial fulfillment of the requirements for the degree of Master of City Planning.

A large number of Section 236 subsidized housing developments are facing financial difficulties. They have been unable to generate sufficient income to cover operating costs and debt service. As a result many subsidized housing developments have gone into default. The issue of subsidized housing facing default has important ramifications. Events leading to and leading after foreclosure has negative repercussions on all parties concerned, especially on low and moderate income families who live in these developments. The greatest effect is the reductions of decent housing to these families.

There exist at present no operational national housing "workout" strategies, nor any definition of the federal government's role in resuing defaulted or about to default multi-family housing.

To analyze issues surrounding distressed subsidized housing, in this thesis we will examine 1) the Section 236 development/management process, to show where it went wrong and how problems arise; 2) how HUD currently deals with the situation; and 3) why additional mechanisms are needed to ameliorate it.

In an effort to reach a better understanding of where HUD went wrong and what new solutions might be possible, housing built under a State housing finance agency, the Massachusetts Housing Finance Agency (MHFA), will be discussed. Methods used by the MHFA in dealing with financially troubled developments will be studied.

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INTRODUCTION

As part of the Great Society program, President Lyndon Johnson proposed the Housing and Urban Development Act of 1968. Section 236 of the Act committed federal subsidies to the development of multi-family housing for people whose income was above that required for acceptance to public housing, but below that needed to afford a decent apartment on the conventional market. Section 236 provided federal insurance for private forty year mortgage loans for projects sponsored by "limited-dividend" and "non-profit" entities. Section 236 also provided for monthly payments from the government directly to the mortgage lender, on behalf of the project owner. The amount of the monthly government payment to the lender was to be equal to the difference between the payments that would be required for principal, interest, and the mortgage insurance premium at the market rate mortgage and the payments that would be required for principal, interest, and mortgage insurance premiums if the mortgage carried an interest rate of one percent.

The purpose of the Section 236 program was to stimulate the participation of private enterprise in the construction of multi-family housing for low and moderate income families. The adoption of a complex system of tax incentives with long-term tax roll-over provisions was to permit private enterprise to play a major role in the housing development process as well as in the operation of completed units. One year after its enactment, multi-family housing starts for subsidized housing had soared. Multi-family subsidized housing starts had risen to over 1
124,000 units in 1971. Between 1969 and 1971, more FHA-insured multifamily units were provided than had been provided under Section 202, Section 221 [d] 3 Below Market Interest Rate (BMIR), during the decade from 1959 through 1968. From 1968 through 1971, 240,490 units were built under the Section 236 program, making up 18.3 percent of all subsidized housing built in that period.³

Today a large number of Section 236 subsidized housing developments are facing financial difficulties. They have been unable to generate sufficient income to cover operating costs and debt service. The costs of utilities and taxes are rising so rapidly that the stream of income from tenants cannot carry the projects. The soaring costs are particularly troublesome because owners of subsidized projects need HUD's approval to raise rents, and HUD wants to keep rents within reach of eligible tenants. While HUD has approved rent increases of as much as fifty percent at some projects; such approval has sometimes worsened problems by increasing the number of vacancies, or by sparking rent strikes by angry tenants. As a result, many subsidized housing developments have gone into default. By the end of June, 1975, HUD either owned or held unpaid mortgages on nearly 2,000 apartment buildings containing over 100,000 dwelling units.⁴ Property values and unpaid mortgages, both subsidized and unsubsidized combined, totaled $2.5 billion.⁵

Financial trouble in housing projects has mainly been caused by inflation driving up operating and maintenance costs to a level where they cannot be recovered through rent increases. Many of these developments are located in economically depressed areas in which the residents
are unable to pay rent increases. Many owners of financially stricken buildings are churches or other non-profit organizational sponsors who lack the necessary operating cash resources, the kind of occupants who can afford rent increases, and the necessary managerial skills.

Besides governmental interaction, other events have had profound effects on housing from 1968 to the present. The nation experienced unusually high rates of inflation. The inflation resulted in steep increases in operating costs for both low income public housing and federally-subsidized low-moderate income housing. Management companies were unable to provide for building maintenance under the original cash flow projections and rent levels. Other events which influenced the financial capacity of federally subsidized housing were the energy crisis and subsequent increases in fuel costs. Those increases required greater sums to be allocated for heating and electricity, an additional strain on operating expenses.

The unforeseen increase in operating expenses contributed largely to the financial distress of subsidized housing projects. When the program received its original authorizations, no attention was given to the possible need for separate operating subsidies.

HUD has proposed legislation to supply necessary funds to deal with part of the problem faced by subsidized housing, but President Ford vetoed the Emergency Housing Act on June 24, 1975. The Act would have addressed the foreclosure dilemma by providing operating subsidies to projects under financial stress.

When owners have defaulted, banks and other lending institutions have turned over the unpaid mortgages to HUD and collected their loans.
In the first ten months of fiscal 1975, HUD found itself responsible for 105 buildings carrying $110.3 million of unpaid mortgages.  

HUD has had to assume responsibility for debt collection after mortgage debt is turned back to it by financial institutions. If a financial remedy that would reinstate the mortgage could not be found, HUD has had to foreclose on these properties. The overall drain on the Federal Housing Administration's (FHA) revenues now exceeds $1.8 billion. In a sale of a foreclosure property, the government recovers about forty-seven cents on the dollar. In the first ten months of fiscal 1975, HUD sold seventy-seven projects to recover $67.2 million owners had not paid. HUD lost $33.3 million, or an average of $5,654 on each of the 5,889 apartments in the buildings sold. 

The selling of foreclosed multi-family developments has jeopardized the housing of thousands of low income and moderate income tenants. The reason is that projects usually must be sold without the federal subsidies, thus eliminating this housing as a resource for low to moderate income households.

The multi-family housing failures are concentrated in about twenty large cities, including Detroit, Boston, Dallas, San Francisco, Los Angeles, New York, and Cleveland. These housing failures hurt the tax base of these cities and also the supply of decent housing for low income families.

Some of the problems faced by subsidized housing are actually inherent to the program structure. Subsidized housing programs have come under serious attack from all quarters. FHA processing was too
slow and project development was enmeshed in red tape. Even with FHA reviews, construction was shoddy and architectural designs were poor. In some communities the subsidized units were placed in the least desireable areas; that is, they were placed in environmentally dreary locations (e.g., near a garbage dump) or in too-crowded poor residential neighborhoods. In other communities, too few of these units were built in urban and rural poverty areas, accessible to the populations they were meant to serve. In still others, they were built in areas where school facilities, social services, etc., were unavailable to poor families. The subsidies offered were not sufficient and did not aid the families who most needed them.

Private enterprise was making large profits at the expense of low and moderate income families through the sale of syndications to investors for tax shelter purposes. Tax incentives did not work and offered too much gain for too little work in some cases, and too little gain for too much work in other cases. Management was poor and there were no incentives to make it better.

In an attempt to deal with financially troubled developments, HUD exempted (1974) federally subsidized developments from local rent control. Since January 5, 1973, a moratorium on new Section 236 developments has been in effect as a result of foreclosures, which has tremendously decreased production of housing for low and moderate income families. As of January, 1975, HUD has also declared a moratorium on foreclosures of nonprofit subsidized projects on which it holds the mortgage, rescuing about one hundred projects from default.

The Nixon Administration tried to iron out the difficulties in the
program. Goals for the production of housing were changed from quantity to quality. Production slowed to a crawl amidst cries of complaint, not only from the private sector which was utilizing these programs, but also from many of the tenant groups being served by new subsidized units. Problems overwhelmed the program and the federal government was in danger of becoming the nation's largest slum landlord. As of this date, no other formal decision has been reached that could resolve the problems of distressed subsidized housing. No simple answers exist for the financial problems that subsidized housing is encountering. There exist at present no operational national housing "workout" strategies, nor any definition of the federal government's role in rescuing defaulted or about to default multi-family housing.

To analyze issues surrounding distressed subsidized housing, in this thesis we will examine 1) the Section 236 development/management process, to show where it went wrong and how problems arise; 2) how HUD currently deals with the situation; and 3) why additional mechanisms are needed to ameliorate it.

In an effort to reach a better understanding of where HUD went wrong and what new solutions might be possible, housing built under a State housing finance agency, the Massachusetts Housing Finance Agency (MHFA), will be discussed. Methods used by the MHFA in dealing with financially troubled developments will be studied.

The thesis is organized as follows: Chapter One provides a description and analysis of the original structure and goals of the Section 236 program, with particular emphasis on the system for sponsor participa-
tion created by the program.

Chapter Two describes the processing and development of a Section 236 project, with emphasis on the development/management process.

Chapter Three focuses on typical mechanisms used by HUD to deal with financially troubled projects.

As a comparative analysis, Chapter Four discusses the structure and goals of the Massachusetts Housing Finance Agency (MHFA). Chapter Five discusses the development/management process under the MHFA, and Chapter Six describes the MHFA's efforts to deal with financially troubled developments.

Chapter Seven closely examines a specific aid to financially troubled developments, the workout, with particular emphasis on its legal and financial ramifications. Chapter Eight looks at further mechanisms to avoid foreclosure, most as yet untried by the MHFA and HUD. Chapter Nine discusses change of ownership in HUD developments as a means of keeping them available to low and moderate income families.

In our concluding remarks, we discuss new alternatives that may be used in the future to bring about more responsible long-term ownership/management of subsidized housing.
Chapter One

THE SECTION 236 PROGRAM STRUCTURE

In order to understand how the section 236 program got into so much trouble, it is necessary to understand the operating assumptions and guidelines which have structured it. The purpose of the Section 236 program, which was a replacement of Section 221 [d] 3, was to promote the development of low and moderate income housing. Under the prior Section 221 [d] 3, the FHA was authorized to insure a private mortgage loan for the development of multi-family housing projects. The loans under this Section bore only a three percent "below market" interest rate. Another government instrument, the Federal National Mortgage Association (FNMA), had to buy the mortgage receivable from the private lender upon the completion of construction. ¹

From 1961 through 1967, there was only a limited amount of private housing that was developed under the Section 221 [d] 3 BMIR program. The housing activity was outside rural areas and center city areas where housing was often most needed.²

The reports of the President's Commission on Civil Disorders (1968) and the President's Commission on Urban Housing (1968) predicted drastic social disintegration in the cities if more low and moderate income housing were not forthcoming.¹⁴ Some of the reasons for the absence of private sector activity were the lack of adequate financial incentives and the high amount of risk involved to developers, builders and investors for construction in rural areas. The problem was that under the
FHA's multi-family program, low interest rates and extended mortgage terms all reduced rents, but limited the cash return to project owners. According to the regulation under the Section 221[d]3 BMIR program, owners's cash flow from equity (ten percent of total project cost), is limited to a six percent return. Thus, there was little reason for a private developer to undertake the development of low and moderate income housing projects, as opposed to the far less risky, and potentially far more regarding alternative of developing conventional residential housing.

To overcome the inadequacies of Section 221[d]3 BMIR, a new program was formulated (Section 236) which was structured to promote developer and sponsor participation in the production of low and moderate income housing. Under Section 236, housing is developed by private builders. Projects are financed through private lending institutions and the mortgages are insured by the FHA at a market interest rate. Each tenant pays either a basic rental (calculated on the assumption of a mortgage with a one percent interest rate), or twenty-five percent of his adjusted income, whichever is greater. Rent collected by the mortgagor in excess of basic charges is returned to HUD. Ownership is restricted to nonprofit and limited profit sponsors.

The purpose of this subsidy is to expand low income housing production by making returns on investment under the HUD subsidy programs competitive with the return on conventionally financed construction. The extension of the mortgage term to forty years and the interest reduction subsidy, providing lower debt service, usually make rents twenty-five percent lower than those for conventional apartments.
This allows builders to locate developments in areas where tenants' incomes traditionally have been insufficient to meet open market rents.

The purpose of both the Tax Reform Act of 1969 and the Housing and Urban Development Act of 1968 was to change previous programs by providing tax aid and other incentives for the private development of low and moderate income housing. Under Section 236, substantial tax benefits are afforded to project owners. Under the prior Section 221[d]3 program, HUD and the FNMA made a three percent interest rate loan for the development of the project. Under a three percent mortgage schedule, the owner's initial payments consisted primarily of nondeductible principle amortization. By contrast, under the Section 236 program, an owner can execute a mortgage for the market rate of interest up to a maximum rate specified by HUD.

A portion of the debt service is paid by HUD to the lender on behalf of the low income tenants. For federal income tax purposes, the owner is required to treat HUD's interest reduction payments to the lender as gross income, as though they were at the higher rate. However, the owner is permitted to deduct the full market interest provided under the terms of the mortgage on his income tax. Under a market rate interest mortgage, a greater portion of the owner's initial debt service payments consists of deductible interest than was the case under a Section 221[d]3 three percent interest rate mortgage.

The major investment incentive in a Section 236 development is the tax shelter that it can provide to persons in a fifty percent or
higher income tax bracket. Under the 1969 Tax Reform Act, housing projects insured by the FHA under Section 236 are subject to the same tax benefits afforded all new residential property. The Tax Reform Act permits continued application of accelerated depreciation (double-declining balance or sum-of-the-years digits methods) to all new residential property. But for investors in low to moderate income housing it also provides: 1) favorable capital gains treatment of sales proceeds representing the excess of accelerated-over-straight-line depreciation, and 2) generous roll-over provisions.

Because of the special tax provisions under the 1969 Tax Reform Act, investments in 236 projects appear fairly attractive to high income individuals interested in sheltering income. One of the incentives derives from the rule for recapture of depreciation (that is, the gain on a sale or a portion of it which is in excess of straight-line depreciation is taxable at ordinary income rates, rather than as capital gains). The Tax Reform Act substantially changed the recapture rules so that accelerated depreciation on nonresidential property is completely recaptured, regardless of the holding period. On residential rental housing however, recapture was increased to one-hundred percent for the first one-hundred months only, after which percent recapture declines by one percent per month for the next one-hundred months. Thus, after sixteen years and eight months, the entire gain is considered a capital gain.

With respect to government-sponsored housing, Congress created an even greater tax break by preserving the pre-1969 recapture rules,
which provided for no recapture after a ten year holding period. This provision suggests a greater possibility of trading ordinary losses for capital gain upon sale; but the FHA restricts sale or even refinancing for a period of up to twenty years. Sale is allowed only to an approved tenant group or cooperative, but cash return on such a sale is restricted.

In an attempt to encourage sale to tenant groups or cooperatives and production of government-sponsored housing, a tax "rollover" provision was established. Under the "rollover" provision, sale of a Section 236 project is not to be currently taxed if the seller reinvests the proceeds of the sale in another federally-assisted project. It was intended to be a tax incentive for conversion to tenant ownership, but the provision has never operated as such successfully. The sale price of a project was fixed by HUD, which created little incentive for electing the rollover; little cash generated and the depreciable base for the replacement project is further reduced by the amount of gain not recognized, thus reducing the tax shelter otherwise available in the second project. The only advantage of the rollover provision is a possible escape valve for a situation in which a project has reached the crossover point at the end of twenty years, but cannot be sold on the open market for more than the mortgage. As a result of the reduction of the depreciable base, by reason of tax losses taken by investors, a substantial gain would be realized. Since the partnership would have no cash to pay the tax on the gain, it might prefer to sell to a tenant group and use the rollover.
These tax incentives have a direct impact on investors, but are intended through their indirect effects to function as consumer-use subsidies. Their objective is to make capital resources available for production of low income housing at a cost to the developer that is competitive with alternative investments of comparable risk. Since an accelerated form of depreciation is taken, many of the tax benefits are used up by the end of the seventh year. At this point the project is of little use to the investor. The only financial reason why the investor would want to keep the project would be to save it from financial difficulty, because, in the event of foreclosure before the 120 month period, the investor is subject to recapture (deductions taken in excess of straight-line depreciation which are subject to taxation at regular income tax rates, instead of at lower capital gains rates).

The financial rewards generated from the development for investors are from an indirect source in the tax system. The gain realized has no relationship to how well the project is managed. Many of the tax benefits are generated in the early years of the development and after this point there is no real financial incentive to hold investors to the project, except to avoid a tax liability from depreciation recapture. The benefits generated have no relationship to ownership-management performance.

**Builder/Sponsor Profit Risk Allowance (BSPRA)**

The actual initial equity required by sponsor/builders is small,
making building under the Section 236 program attractive. Because of the small amount of equity required, the sponsor has little to lose if a development gets into trouble. He would be less willing to work to resolve a problem, therefore, if he has little of his own equity in a development. Also, the small equity requirement permits under-financed sponsors to participate in the program, sponsors who are least able to financially support a development if it falls into financial difficulty. Section 236 offers the sponsor with less risk as compared to conventional apartments, where actual cash equity requirements can be from twenty to thirty percent of the total replacement cost. This allows relatively easy entry into the program.

A financial profile of a hypothetical Section 236 project is shown in Figure I. In this Figure, item five refers to the Builder Sponsor Profit Risk Allowance (BSPRA), which is given by the FHA if an identity of interest between the mortgagor and the contractor exists. BSPRA is included in the replacement cost.

Item eight refers to "Stated Equity", which equals ten percent of replacement cost - in our example, $150,000. The amount of the dividend to the owners from the project is limited to six percent of the stated equity - in our case, $9,000. BSPRA can be used as part of the equity required. The builder sponsor normally leaves the BSPRA in the project as equity and is able to build the project with little cash. Compared with conventional projects, 236 developments permit a much higher loan-to-equity ratio. Actual cash equity can be as low as one and one-half percent of replacement cost - $23,000 in our example.
There are certain out-of-pocket expenses that are not allowed as part of the mortgage: construction loan fees in excess of two percent of the total cost, permanent loan discounts (when the mortgage sells below par), and working capital. Section 236 requires the limited dividend equity to show a working capital equal to two percent of the mortgage. In our example in Figure 1, total out-of-pocket costs equal $63,227.

These out-of-pocket expenses illustrate another feature of the 236 program. If the final construction costs exceed the estimated construction costs, the cost overruns are the responsibility of the mortgagor-sponsor. However, if construction costs are higher than estimated, but the interest expense is lower, the two may offset one another. If total final costs are lower than estimated costs, the out-of-pocket costs (e.g., discount, construction loan fees and contingencies) and cost overruns may become part of the mortgage, as long as the final mortgage does not exceed the original estimate.

In 236 projects where the interest-assistance subsidy effectively reduces the interest rate on a forty-year mortgage to one percent, the developer has a dramatically low constant on the mortgage (a 3.3 percent constant, compared to a 10.4 percent constant on eight percent interest for twenty years). The reduced constant serves to reduce rents for the apartments in a 236 project. Thus, these projects supposedly need not face the normal risks of competition, since they offer rents with with few conventional projects can compete.
Since tax benefits generated from a 236 project are greater than what the builder-sponsor can use, it is generally more profitable to sell the project to investors. As previously mentioned, a Section 236 mortgage provides almost all of the capital needed to permit construction of a multi-family housing project profitable to the sponsors and to the members of the development team. This profit is obtained through operation of the current tax system and the sponsor's ability to raise cash by selling the favorable tax characteristics of the project to others. A sponsor can sell a project for greater than the ten percent stated equity, twelve to twenty percent of the mortgage. This kind of sale to investors is the major source of profit. A sponsor usually is able to obtain these profits within three years after construction of a 236 development. So, in effect, whatever may happen to a development after this period is of little concern to the sponsor; he has already received the maximum financial benefits and has little at stake in the project. There is no personal liability for him in the permanent mortgage, because of the exculpatory provision that frees the builder-developer from personal liability for debt. Figure 2 shows the amount of profit a developer could make on a project.

Extension benefits through the tax system is available only to those projects that avoid foreclosure for a number (three to six) of years; wealthy investors will pay less and demand higher projected returns for projects in urban or rural poverty areas, because of the
greater risk of financial insolvency. Likewise, such investors usually accept a lower return and pay more for an older project in a suburban neighborhood that has few unusual rent-up or management problems, and which may even offer some prospect of a residual value at the end of the twenty year projection period.

The tax benefits generated do not vary with the project's location or the risk entailed. The sponsor's compensation is dependent on the amount he can raise through the sale of tax benefits. The sponsor would get a lower amount of compensation on risky projects; thus the sponsor's compensation decreases as the risk increases. The tax benefits available to a project of a given size do not vary with the risks entailed in the project. In summary, the compensation varies inversely with the risks involved.

The method of compensation for the sponsor is worked out through the tax incentive system, on which investors base the price they are willing to pay to the sponsor. This system weighs the expectation of reward against the risks taken. A sponsor is normally entitled to compensation that is commensurate to the risks involved. The indirect method by which the sponsor realized his compensation and the inflexibility of a tax incentive system based on a depreciation format do not reflect the amount of risk taken by the sponsor.

**The Return to Limited-Partner Investors**

The major gains realized to investors have almost no relationship to the ownership/management performance of the development. Gains are
almost guaranteed and risks to investors are minimized through the structuring of investment. Returns on investment are high enough so that after a few years of operation, the investor can recover his investment. The only risk to investors is the threat of foreclosure, which can produce a tax liability.

The risk on FHA syndications is usually structured so that only a part of the investment is ever at risk to the investors. This is done by staging the investment outlay. Even if the business of renting and operating the project is unsuccessful, the tax shelter achieved to the date of foreclosure normally outweighs the tax on the gain resulting from the foreclosure and the loss of the investment capital; and so results in a net gain to the investors. Limited-partners are only liable for the amount of capital invested, no more.

In the event of a foreclosure of a project by a partnership, the gain realized for federal tax purposes is, in effect, measured by the difference between 1) the amount realized on the sale, and 2) the partnership's depreciated cost for the project. In the case of low and moderate income projects, the entire gain on any such sale is taxed at capital gains rates, unless the sale occurs during the first ten years after the date on which depreciation of the project commences. If the project is foreclosed during this ten year period, all or a portion of the gain is subject to depreciation recapture and is taxed at ordinary income rates. The portion of the gain subject to depreciation recapture is an amount equal to the diffe-
rence between the aggregate amount of depreciation claimed by the partnership and the amount which would have been allowed if the straight-line depreciation method had been used.15

Analysis of Section 236 projects shows that most investors received an after-tax return on investment of between eighteen and twenty-seven percent for fifty percent bracket taxpayers; for seventy percent bracket taxpayers, the after-tax return may be as high as thirty-five percent. The average equity investment for such investors has been between fourteen and sixteen percent of the mortgage.

The investment recovery period is the time required to recoup equity investment through tax savings and cash flow generated by the project. The recovery period ranges from three to six years. Between seventy-five and one-hundred percent of the investment is tax deductible in the first year. Under the present incentive system, the tax benefits run out before twenty years have passed. The FHA-insured mortgages generally run for forty years. After the twentieth year, the ownership entity has little positive financial reason for holding onto the project.

Conclusion

The major housing production incentive for sponsors to participate in under Section 236 is the generation of tax shelter benefits which are sold to investors. Thus it is reasonable to conclude that the government has focused far too much attention on the incentives needed to stimulate the development and building of low and moderate
income housing, and far too little attention on the incentives needed to insure the viable long-term ownership and management of multi-family housing.

The ownership of low and moderate income housing is seen as a burden that must be borne by developers or builders in order to obtain profits which may later have to be used for the actual development and construction of multi-family units. The investors are interested in avoiding an early sale because of the large amounts in taxes that would have to be paid, which could severely reduce the net after-tax return of the project. Because of the fact that there is no further substantial profit generation from the development, there is no incentive to do anything more than keep the project from being foreclosed. The party actually responsible for the operation of the project on behalf of inactive, limited-partner/investors is the developer, who is usually the generally partner, but who has little or none of his funds invested in the project. Except for the developer's desire to maintain credibility and and a favorable reputation in the investment community and with HUD/FHA for the sake of future Section 236 projects, he has little incentive to keep the project operating, much less to provide superior housing services, since the economic benefits have been extracted at the outset of the project.

The "rollover" option does not provide effective incentives for the developer to sell to the tenants. The only conditions under which Section 236 owners would be interested in selling a project to a tenant group would be 1) if the tenant group could pay a price well in
excess of the outstanding mortgage balance, and probably well in excess of any amount which could be refinanced, or 2) if the developer is willing to obtain less than his maximum profit from a second project by offering it as a bail-out investment for his partners in a first project which has become impossible to operate.

The Section 236 program was mainly intended to promote the production of housing without regard to long-term viability. HUD officials ordered local FHA offices to low customary underwriting standards in order to increase approvals of housing proposals. Because of the emphasis on production, concern for economic viability was not of primary importance. Many units were built in weak market areas. These area offices, under pressure to produce, deliberately lowered operating expense budgets to "make numbers work". They justified this by reasoning that rents could later be increased to cover operating costs. This strategy might work if operating expenses remain constant; but economic effects have caused expenses to escalate to a point where it has become beyond the ability of tenants to pay.
The purpose of this chapter is to analyze the weaknesses in the development/management process that are contributing factors to the problems of distressed subsidized housing. A step-by-step analysis of procedures outlined under the Section 236 program follows, in order to illuminate the inherent weaknesses in the program. The description outlines the pre-feasibility state through commitment and ends with the final closing.

Pre-feasibility to Final Closing

A developer has located a piece of land which is suitable for the kind of development he seeks to build. He carries out the market research necessary to determine whether the demand for subsidized housing exists for that location and whether the rents that would be generated at HUD prescribed levels would be sufficient to justify the investment. With this basic information collected, the developer has a pre-feasibility conference with the local FHA office.

At the pre-feasibility conference the developer describes the nature of the project. Feasibility is checked by comparing the rough estimate of rent levels and operating costs in the proposed project with the current rent levels and vacancy rates in the area. The purpose of the conference is to let the HUD office know of the
developer's plans so that HUD has the opportunity to offer its view of the project's feasibility at an early stage. At this stage, the HUD office indicates what the chances are for receiving a allocation of subsidies. If the office believes that the market in an area is "soft" or if the office is short of subsidy funds, an attempt is made to keep a sponsor from wasting his time in submitting an application. In cases in which HUD gives a favorable judgment on the potential of the project, the developer then begins to work on the subsequent stages, which include a management plan for the project and a letter of feasibility. ²

The key part of the application for a letter of feasibility is the submission of FHA Form 2013, which is the application for project mortgage insurance. The feasibility of the project is indicated by the financial calculations included on this form. The information supplied determines whether the proposed rent levels can support the mortgage payments, the operating expenses, and the six percent cash distribution on the "stated equity". ³ The size of the mortgage is limited by the rents that can be charged. The amount of rent that can be charged is restricted by FHA tenant income limits, which are 135 percent of the limits established for public housing in that area.

Between one and six months after submittal of the 2013 form and related documents (such as evidence of site control, personal financial and credit statements of the sponsor, and equal employment opportunity certification), the HUD area office calls the proposed sponsor
in for a feasibility conference. At this conference a more detailed discussion of market and economic feasibility, project location, site layout and design, and the proposed management plan takes place. If HUD finds the project feasible, it establishes target dates, reserves the subsidy funds required by the project, and issues a letter of feasibility inviting the potential sponsor to submit an application for firm (conditional) commitment. A time limit of sixty to ninety days is set for submittal of this second application.

At this point, the sponsor instructs his architects to draw up final plans and to refine cost estimates through negotiations with the contractors, after which another 2013 form is submitted with the refined cost estimates. If approved, a letter of conditional commitment is issued by HUD.

The developer negotiates a fixed price with the builder and then applies for a firm commitment from HUD by submitting a revised 2013 form, accompanied by architectural plans and specifications, a land survey and a surveyor's certificate. The 2013 form is now based on firm prices, not estimates. If everything meets proper specifications, HUD issues a firm commitment for mortgage insurance and the interest subsidy.

The next stage is the initial closing, at which construction can begin. With firm commitment, the developer has completed the bulk of the development work prior to the start of construction. The developer has met HUD requirements, and HUD has legally bound itself to supply mortgage insurance and an interest subsidy within specified limits.
When ninety-five to ninety-seven percent of the construction is completed and certified by both architects and HUD inspectors, a Permission to Occupy is issued by HUD. At this point, rental of units may begin - prior to the last step in the development process, final closing.

Final closing constitutes the final endorsement of the mortgage instrument, putting into effect both the insurance on the permanent loan and subsidization of the mortgage on the completed project.

**Determination of Feasibility**

The method used for determining feasibility, during initial HUD development/management processes, places most developments at the maximum income limits of its potential tenants. This leaves developments in a bad position to absorb future costs. Much is due to placing a greater proportion of rents as payment for capital costs instead of operating costs, because the developer's profits are generated from the cost of construction.

In filling out 2013 forms, the knowledgeable sponsor generally begins his work on the application by moving from the "bottom upward". The 2013 form is the most crucial worksheet since it incorporates the numbers upon which project rentals and project feasibility are determined. Thus, a sponsor can look first at the regular income limits applicable to the jurisdiction in which the project is planned. By taking twenty-five percent of those income limits based on maximum family sizes for the types of units planned (e.g., two bedroom units,
four persons; three bedroom units, six persons), the developer can calculate the "administrative rent limits" - the maximum amounts which can be paid by qualified individuals and families for rental purposes in a Section 236 project. Once these per unit figures have been obtained, the developer can multiply them by the number of units (and applicable bedroom distribution) in the project, resulting in the maximum rental charges that can be derived from the project. Reducing these revenues by a five percent combined vacancy and collection loss factor provides the figures that are acceptable to HUD.

The developer now plugs into his calculations the operating, maintenance, and real estate tax cost estimates obtained from the local HUD office. These costs, originally set by HUD, were based on pass estimates on suburban housing developments. These estimates turned out to be lower than estimated, especially for inner city developments, which require higher operating costs. Developers also have negotiated with HUD offices to lower operating expenses, in order to allow more funds for construction. Subtracting operating cost figures from the adjusted gross income usable for rent purposes leaves an amount that can be assumed to be available for debt service and allowable cash flow. Thereafter, by capitalizing this figure at the expected debt service rate (3.3 percent annual constant for a one-hundred percent subsidized 236 project), the sponsor obtains his working figure for replacement cost purposes.

Once the developer has this replacement cost figure, he can break it down into its component parts. At this point he has a rough idea
as to what he intends to construct on the site. In effect, the pre-determined replacement cost allows the "numbers" to dictate which type of construction and which unit sizes are possible. Again, the sponsor works backwards from the basic replacement cost figures. Taking out the maximum allowable amounts for architectural, mortgagee, legal and organizational, special management, and title and recording fees, the sponsor/developer then calculates the fees to be paid to the FHA for processing purposes and to the Federal National Mortgage Association/Government National Mortgage Association (FNMA/GNMA) for purchase of the permanent mortgage. Then the estimated land value for the site is plugged into the calculations. Once these figures have been obtained, the developer subtracts them from the gross amount left for replacement cost. The remainder constitutes the amount available for construction, general overhead, insurance, taxes, and bonding purposes. Within the confines posed by that figure, the sponsor must decide what can be built in terms of square feet, project design, and basic amenities.

The fundamental principle for determining feasibility of a 236 project is that the project income be greater than or equal to expenses, and that a market exist which is able to provide the projected income. Under this subsidized housing program the interest is lower, potential tenants must have incomes within the applicable limits, and rents must not exceed twenty-five percent of adjusted income. These income limits put an upper boundary on mortgage amount and operating costs.
Through manipulation of various numbers, a sponsor is able to justify the feasibility of a development. Manipulation of these numbers has certain ramifications to a development's future viability. Historically, the operational cost limits set by HUD to determine feasibility for a 236 project were unrealistically low. Sponsors have used maximum payments by the tenants with the highest qualifying incomes in the jurisdiction to determine feasibility. Insufficient allowance was made for temporary increases in vacancies, rent delinquency, operating cost increases, or errors in cost estimates. Actual construction costs have also not permitted for these allowances. In actual practice feasibility was achieved on paper, but with no margin for construction cost increases due to inflation and/or delays. What has occurred, therefore, is that sponsors have taken maximum advantage of production incentives. By taking this advantage, sponsors have obtained maximum up-front benefits.

The amount that a sponsor can earn in any project is primarily a function of the available tax benefits that can be converted to cash through syndication of the project. Accordingly, it is to the sponsor's advantage to build the most expensive structure which would still be rentable after application of the Section 236 subsidy. The sponsor has no incentive to achieve overall construction cost savings. The more the project costs, the higher its depreciable base will be, and since the sponsor's profit is derived largely from what others will pay for tax deductions attributable to depreciation, any attempt to save on costs at this point is directly counter to the sponsor's
interest. This has led to maximum allowable rents which produces maximum allowable mortgages, which in turn limits the margin available to absorb future operating cost increases. Large mortgages mean larger amounts of profit from the sale of tax shelters. In order to maximize profits with a Section 236 project, a trade-off between construction costs and operating costs has had to be made: there has been the necessity of choosing between a low, unrealistic estimate of operating costs or less durable construction. Even if a proper balance is achieved, there is often little margin for increase, since feasibility is based on maximum allowable rents. Sponsors prefer to use low estimates of operating costs in order to allow a larger proportion of the rent to support a larger mortgage. Each dollar used to pay debt service can increase the mortgage thirty to thirty-five dollars. Since the sponsor is a builder or seller of tax syndications, increase of the mortgage is an increase of profit. The majority of the profits in a 236 project is obtained in the production of the housing, not in its operation.

Another expense which has demanded higher capital expenditure and increased financial pressure is land cost. Housing programs operating outside urban areas have no mechanism to prevent land speculation. This lack has resulted in higher land cost and accordingly higher rents. Many developers have it in their interest to obtain high prices in land because additional profits are made thereby. Some of the high prices are justified due to holding period expenses and legal fees required for rezoning and to deal with legal community op-
Part of the reason why a greater proportion of the rents must go toward construction is due to a provision in the Davis-Bacon Act of 1931. The Davis-Bacon Act, which is incorporated in the National Housing Act, requires the Department of Labor to determine "prevailing" relevant wages and fringe benefits, which then become the minimum standards for workers on federally-funded or sponsored projects. The purpose is to protect local labor who desire to work on federally-funded construction from the competition of low-wage non-local labor. Consequently, contractors building HUD-insured subsidized or non-subsidized multi-family housing projects are required by law to pay these "prevailing" wages.

Studies of the impact of the Davis-Bacon Act on the construction industry indicate that "prevailing" wages, as determined by the Department of Labor, have often been higher than actual market wages for local labor. In such instances, the cost of labor to builders of federally-sponsored projects rises because workers can be engaged only at premium wages. This means higher rents for those who are in the worst position to absorb an extra housing cost, the tenants.

Changes in construction costs and interest rates have considerably more impact on basic rents than do changes in operating costs. If sponsors were encouraged to lower construction costs, the resulting projects would be more feasible. There would be more money for operating expenses, but this might be offset by increased need for maintenance due to lower construction quality. Ultimately, if a delicate
balance between operation and construction costs could be maintained, long-term viability could be achieved.

The Construction Phase

During the construction period, financial viability can be jeopardized. First, as we have seen a development's total cost can bring rents up to the maximum permissible limits, which narrows the range of eligible tenants and eliminates any margin for future cost increases. Second, cost increases during construction can also lessen or eliminate an existing safety margin. An increase in the mortgage and an equivalent increase in amortization expenses, without being offset by a corresponding HUD-approved rent adjustment, can also eliminate any margin and create deficits.

Further problems may arise that can affect the viability of the project. Delays in construction, vandalism, and organized opposition lead to increases in cost and fixed expenses, without a corresponding increase in project income. Because of the cost limitations set by HUD, sponsors have understated true cost in order to obtain an FHA commitment. Cost over-runs and inflation sometimes occur later which may or may not be covered by a rent increase.

The increases in various capital costs during construction has forced rents to increase to their maximum levels allowable by HUD. This has hindered the marketability of these units. Rent increases that are granted for unforseen contingencies have in turn narrowed the range of eligible families.
Construction costs, which have experienced a ten to fifteen percent increase annually due to higher labor and material costs, have increasingly demanded a greater proportion of the rental dollar. These development costs have increased faster than the rent-paying ability of low and moderate income families.

Management

The sponsor of a subsidized multi-family housing project must develop an effective management plan and then employ management personnel and procedures to carry it out. In implementing the management plan, a mortgagor frequently obtains the services of a managing agent and resident manager. The decision to employ a managing agent or to hire a management staff is usually based on such factors as cost availability of resources, the size of the project, and the number of other projects for which the sponsor is responsible.

Once construction is sufficiently advanced and the management entity is selected and approved by HUD, the task of renting units to eligible tenants begins. This process involves advertising the availability of rental units in the project and the screening of prospective tenants to determine that they meet the eligibility requirements established by the sponsor and HUD.

During the "normal management" phase, the project manager may have to perform additional functions, which include requesting rent increases when warranted by higher operating costs, and ensuring that construction defects are discovered and corrected within the
construction warranty period; and correcting damage when facilities are destroyed by fire or other accidental causes.

These added management functions and others, such as collection of rent arrearages, eviction of tenants and yearly verification of tenants' income, have consumed a large proportion of management time which could have been applied to other functions in a development. Some of these activities (e.g., verification of income), are usually not part of conventional management duties but must be done without financial compensation. Added attention to rent collection and tenant eviction has been required due to the nature of projects, especially in core poverty areas where rent arrearages can be abnormally high. Management fees provided do not allow for adequate management services to cover these additional duties. This has put extra burdens on management, for which it does not have necessary resources to cope with effectively.

Even if management fees were allowed to increase, 236 subsidies could not pay for such an increase. The 236 subsidy funds are fixed and there are no subsidy sources to fund increases in operating costs. When expenses have outrun revenues, the mortgagor will have asked for deferment of debt service payments to pay for operating expenses. Maintenance will have been deferred and housing services will have deteriorated because of a lack of funds.

Having inadequate funds to meet expenses has occurred because HUD has limited the proportion of net rent allocated to management, and the sponsor is constrained to keep to the numbers placed on the FHA
2013 application. HUD requirements for management staffing and unanticipated legal and staff activities result in higher than actual costs than those calculated for the feasibility studies. Without the necessary funds, the sponsor must operate with a less-than-adequate management staff.

Tenant-Management Relations

The tenant-management relationship is an important factor in the financial stability of a project. Good management results in lower operating costs. As the Urban Institute points out:

...Successful management is a blend of firmness, management responsiveness and occupant concern. Firmness means getting down and enforcing rules of behavior for occupants consistently. Management responsiveness encompasses heeding requests by residents for repairing and providing recreational space. Occupant concern covers a wide range of behavior, attitudes and interests, including the way residents care for their apartments and their organized concern for the social life of the development.15

A mutually respectful relationship between tenant and manager is correlated with fewer rent collection problems and careful maintenance of the property by both parties;16 in turn, the tenant-management relationship is affected by a variety of factors, including the degree to which management and tenant responsibilities are clearly defined and communicated, and the degree of accuracy of the tenants' perception of management's priorities and responsiveness to tenant needs.

The breakdown of communication between management and tenants has led, in many cases, to neighborhood apathy and to tenant abuse of the
housing stock, resulting in higher than average maintenance costs. This problem has been especially evident in subsidized housing located in the core poverty areas. Lack of funds for adequate maintenance and management services has also contributed to tenants' dissatisfaction, which has led to the breakdown of communication.

Operating Costs

Actual operating costs turn out higher than those predicted in feasibility studies. One of the major cost items that has escalated is fuel costs. Fuel costs have increased as much as 200 percent over original estimates. The FHA has refused to grant rent increases sufficient to bridge the gap between expected and actual fuel costs. Utility costs and other open-ended costs built into projects from the beginning have increased beyond the initial, often unrealistic, projections, while rent increases have been restricted.

Initial maintenance cost estimates were likewise projected too low. Increases in costs were due to greater-than-anticipated frequency of repairs and higher costs of materials and services. High repair costs have contributed to tenant abuse and more wear on units with many-child low income families has occurred. Inadequacies in design also have resulted in higher maintenance costs.

The use of unrealistic estimates of costs in response to rigid guidelines has resulted in fifty to seventy-five percent underestimations of actual operating costs, on the average. FHA inexperience with
low income projects has also led to miscalculations of frequency of repairs, which in turn have led to housing deterioration and the breakdown of tenant-management relations. Strict limits on building costs have led to modest design requirements, premature wear, and increases in operating costs, because of low construction quality.

Increasing tax rates has been one of the fastest rising expenses in subsidized housing. Because there is no federal policy on tax rates for subsidized housing, projects are taxed at the discretion of local assessing departments. Most projects try to obtain special, low tax assessments. While many special deals are arranged, few are legally binding. Many cities naturally feel that special deals are undermining their tax base, and they raise taxes, as has been the case in Boston.

Operating costs have increased without any available source being available to pay for these increases. Maximum rent levels have been achieved, and housing developments are hopelessly locked into a position which leaves them unable to obtain significant financial relief.

Rents

Rental limits on 236 projects are 135 percent of local public housing entry limits. In Section 236 a minimum income is determined by the regulation that a family may pay no more than thirty-five percent of its income for rent. For families with incomes below the public housing limits, leased housing and rent supplement units may be avai-
able that allow the families to pay only twenty-five percent of their adjusted income for rent, with the rent subsidy paying the balance. 19

The basic rents tend to stretch to the very limit the ability of eligible families to pay. Rent increases that arise after occupancy may be more feasible if the project has been rented to tenants near the upper income limit than if most tenants were straining their budgets with thirty to thirty-five percent of their incomes going for rent.

In conventional developments, only a small rent increase may be needed to cover higher costs, because rents are at higher levels than subsidized rents are. But in subsidized low income units, a higher percentage increase is needed to cover the same increase in costs. In the latter situation, however, there is great resistance to such a rent increase. Approval of an increase from HUD may take as long as eighteen months because of bureaucratic slowfootedness and the paperwork required. 20 By the time this period has elapsed projects are desperately in need of funds, since increases are granted on the basis of costs already incurred, not on projected costs. If managers have to file another request for another approval, an additional one to five months will elapse before the increase can be collected. By that time, seven to twenty-three months may have passed since the need for more operating funds was first documented. This delay contributes to the operating cost squeeze in subsidized housing projects.

Rent collection has been another problem. Notification procedures can use up valuable time that might otherwise be devoted to other management tasks.
Conclusion

In our examination of HUD's development/management phase and processing of applicants for Section 236 subsidized multi-family housing, we have discussed substantial financial and programmatic problems.

A greater portion of the rental dollar has been used to pay for construction and less has been available for operating costs. Very little margin has been available to absorb cost increases, and many original operational cost estimates have been unrealistically low. HUD has confined management to these original unrealistic figures, which has resulted in inadequate management services. Even if rent increases have been granted to meet higher costs, tenants have not had the financial ability to pay for these increases.

HUD has taken an almost passive role in monitoring and servicing multi-family projects. HUD has not given enough attention to its portfolio, which requires daily notice from the local offices to process rent increases, review the management and maintenance of insured projects, and to monitor financial data supplied by the mortgagor.
Default

HUD defines a fiscal default for a multi-family project as "the failure of mortgagor to make any payments due under, or required to be paid pursuant, to the term of the insured mortgage." Default exists as soon as one mortgage payment is missed. If a fiscal default occurs and is not remedied within thirty days, the mortgagee is entitled to file a claim on the mortgage insured by the FHA. After the expiration of this thirty-day grace period, the mortgagee may notify HUD of the default. The mortgagor may receive permission to suspend payment to the replacement reserve in lieu of rent increases to meet costs. Financially troubled projects may also use funds in residual receipt accounts to offset operating deficits. Residual receipt funds are income earned from occupancy prior to the final closing.

The Federal National Mortgage Association (FNMA) is almost always the permanent mortgagee under HUD subsidized multi-family programs; sometimes acting for itself, and sometimes acting under contract for the Government National Mortgage Association (GNMA). The FNMA usually sends out late notices to mortgagors on both the tenth and twentieth of each month (the due date is the first of the month), at times maintains verbal communication with the local HUD office, and typically notifies HUD officially of the default within fifty days of its occurrence.
Generally, prior to submission of a default notice, the mortgagee and/or the mortgagor will have been in informal contact with HUD. When HUD receives informal notice that a project is in trouble and that a default may occur, there are several options it may employ.

First, HUD can undertake a study on the causes of the default and the physical condition of the property, including a suggested plan for achieving a mortgage reinstatement. During the regulatory period, after the thirty-day grace period, the mortgagee must decide whether to assign the mortgage to HUD or to foreclose.

As soon as the causes of default can be determined, the mortgagor and HUD usually present a plan of reinstatement to the HUD central office and the mortgagee. The mortgagee then decides whether to agree with the plan. The FNMA has sometimes been reluctant to swerve from its written regulations concerning the assignment of defaulted project mortgages.3

The reinstatement plan requires some form of mortgagee relief. It can take several forms. There can be a deferment or a suspension of deposits to the replacement reserve fund. The suspended payments do not have to be repaid. If this method is applied early enough, it can help.

Another form of relief is the deferment of principal payments, which typically are followed by a recasting or modification of the remaining mortgage payments. The local office makes recommendations to the central office, which then modifies or approves the plan. The modification is for a definite period and may be renewed indefinitely.
but a practical limitation is that modification effectively increases principal and interest payments for the rest of the fixed forty year mortgage period and will, therefore, only increase the fixed costs for the project in the future.4

If the methods cited above are not found to be applicable, the mortgagor may then seek a forbearance agreement, which is more extensive than a principal deferment. Forbearance agreements suspend regular mortgage payments, including interest, during which time the mortgagor agrees to pay all operating and maintenance expenses and to meet all mortgage accrual and payments, except principal and interest. Usually the FNMA, the mortgagee in most cases, will not agree to any sort of forbearance agreement covering both principal and interest. It is firm FNMA policy that deferment of interest is not acceptable.5

Assignment

If all else fails and the mortgagee elects to collect insurance benefits, the mortgagee has the option to foreclose the loan and convey the title to HUD or to assign the mortgage to HUD. The usual procedure is assignment, which is faster and less costly than foreclosure to the mortgagee.

Once the mortgagee has made his choice, HUD must process the claim for insurance benefits, making sure that the mortgagee has met his obligations. When the mortgagee has assigned the mortgage to HUD, all of its responsibilities end. HUD must establish a servicing program and undertake the routine collection of rents, formerly performed
by the mortgagee.  

HUD gives the partial settlement, amounting to ninety percent of the unpaid principal balance, to the mortgagee. HUD may at this time contact the mortgagor and advise its representatives that unless the mortgage account is brought up to date, HUD will institute foreclosure proceedings promptly after assignment. This procedure is sometimes effective with the limited dividend mortgagor who may face recapture of depreciation. The other course of action is to hold the mortgage and work with the mortgagor toward reinstatement. HUD's usual policy is to give the mortgagor an opportunity to reinstate the mortgage if the full cooperation of the mortgagor can be anticipated and if there actually exists a possibility of reinstatement within a reasonable period of time. 

HUD's status as mortgagee increases the intensity of its involvement. More frequent inspections, and monitoring of the project are undertaken. Once HUD takes a mortgagee under assignment, it remains the mortgagee and holds the mortgage, irrespective of whether the mortgagor remains in default, or HUD forecloses and assigns the mortgage for sale at public bid.

If HUD chooses to reinstate the mortgage, there are four courses that can be followed: 1) informal forbearance, 2) suspension or deferment of reserve, 3) provisional work-out arrangements, and 4) permanent modification agreements. These four options are described in detail below.

1) Informal forbearance is issued only when one or two mortgage installments are unpaid and when early reinstatement of debt service
terms is likely. Informal forbearance amounts to HUD's agreement to forbear from taking legal action to enforce the terms of the mortgage.

2) A suspension or deferment of payments to the reserve for replacement is a mild measure designed to help those mortgagors whose delinquency is small and for whom chances of reinstatement are good.

3) If a stronger form of relief is needed, a work-out agreement can be implemented. It provides the maximum amount of financial relief available to delinquent mortgagors without modification of the terms of the existing mortgage. The greater amount of either net cash on hand at the end of the month or the sum of the monthly service charges (one-half percent of the outstanding mortgage balance) is paid to HUD. Regular deposits to an escrow account for the payment of taxes, and a fixed dollar amount agreed upon by the mortgagor and HUD are also paid each month.

If there is a default under the work-out agreement, the property is foreclosed by HUD. Work-out agreements are continued on a month-to-month basis. The local HUD office makes a recommendation of a work-out arrangement and the HUD central office makes the final decision.

4) From past performances, this relief measure usually fails to bring all charges and payments up to date. A permanent modification is used at this point to incorporate unpaid amounts into the mortgage principal, extend the term, and permanently alter the payment schedule.

When a permanent modification fails, HUD forecloses to take title of the property. Once it has acquired a project, HUD assumes the responsibilities of the owner. It hires a managing agent to collect
rents and oversees most of the project's day-to-day operations. HUD's objective as an owner is not to hold the property permanently, however, but to sell it as soon as possible for as high a price as it can obtain.

Conclusion

Mechanisms available to deal with default only postpone the date on which, ultimately, a financially troubled development is foreclosed. No major source of funds is available under HUD default servicing to effectively deal with problems of financially troubled developments. Remedies employed are either implemented too late or are inadequate to really be able to turn developments around.

Deterioration in project finances increases since methods of relief are only superficial cures and cannot produce adequate resources for maintenance and management services.
Chapter Four

THE MASSACHUSETTS HOUSING FINANCE AGENCY PROGRAM STRUCTURE

As a comparative analysis, in this Chapter we shall discuss the program structure of the Massachusetts Housing Finance Agency (MHFA) to find how its program provides certain safeguards against financially troubled housing. We will discuss what the MHFA does, why it is able to be effective and what mechanism it has employed to guard against foreclosure. The relative financial autonomy of the MHFA and the consequent profit motivation to support itself has been instrumental in its success. The combination of administrative independence and financial responsibility has given the MHFA a chance to innovate and experiment, and has required the agency to invest carefully.

The Massachusetts Housing Finance Agency is an independent lending institution created in 1966 by Chapter 708 of the Massachusetts General Laws. Its mandate includes "financing the construction and rehabilitation of well planned, well designed housing projects to be made available at low and moderate rentals for low income persons and families and others." In order to underwrite such projects, the State has authorized the MHFA to sell short-term, tax exempt bonds to finance the full term of the mortgage. The MHFA makes the first mortgage loans, whose interest rates are two to four percent below conventional market rates, to nonprofit and limited-dividend developers for the construction of multi-family housing developments.

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Different from federal low and moderate income housing at the time, the MHFA was to provide housing for a limited number of low income families in all-State funded housing. State subsidies through direct appropriation and agency profits were to be used as one way of reaching low income families.

The MHFA invites development proposals from prospective developers, evaluates the proposals, and agrees to finance some of the proposed developments. The incentives afforded to developers on State financed housing are the same as those on HUD-insured subsidized housing. The sale of tax benefits is the major source of profit to developers.

The MHFA arranges with HUD on an annual basis for a certain number of 236 units for the use of the MHFA developers. Throughout this process, the MHFA's primary role is that of a mortgage lender. It selects and monitors its projects to assure the financial security of its bondholders and to foster the social interests of the State.

Although the MHFA's bond-financed lending program is financially assisted via Section 236 subsidies, there are other programs used by the MHFA in addition to the basic 236 program. The State provided 13A interest subsidies when HUD suspended the flow of Section 236 subsidies. At present, the MHFA has combined 13A and 236 subsidies in its housing developments. Massachusetts also implemented its own 707 leased-housing program, similar to the federal leased-housing program.²

In addition, Massachusetts aggressively pursued federal 236 subsidies, rent supplements, and leased-housing subsidies, because the continued existence and effectiveness of the MHFA depends upon such
funds.

The MHFA has a board which is appointed by the Governor of the Commonwealth. Five of the members serve seven-year terms. By law, the board must include persons experienced in mortgage banking, architecture or city or regional planning, and/or real estate transactions. The Secretary of the Executive Office of Communities and Development and the Commissioner of the Department of Corporations and Taxation are members ex officio. Considering the nature of the financing source, MHFA board members have regarded the fiscal soundness of each individual project as the pre-eminent consideration.

The MHFA is examined by independent State auditors, who investigate programmatic as well as financial areas of the agency. These auditors, however, have no enforcement authority.

Because the agency is not supported by tax revenues from the Commonwealth, it must support itself on fees charged to developers on mortgage loans. Because the MHFA must raise funds from the bond market, a high degree of security is required on the bonds and notes. In addition to the State's "moral obligation", which provides some security, MHFA projects must be financially solvent.

Effectiveness of the MHFA

The position the MHFA takes as a mortgagee makes it more actively involved in the projects and thereby in a position to control many of the risks. The controls on risk is the key to the success of the MHFA.

The MHFA has played an active monitoring role. It has assumed tasks normally associated with both the developer and the mortgage
lender. The MHFA has played an important role in reviewing sites. It has actively solicited proposals from developers and encouraged developments in particular parts of the State. It has been active also in determining the unit distribution of its projects.

The independence with which the MHFA has been able to act has contributed to its effectiveness. The MHFA must meet its administrative and bad-debt expense through the generation of fees on the sale of their notes and bonds. The fees generated allow reserves to be built up.

The MHFA does not have the same federal restriction on reviewing housing proposals as does HUD. This has helped simplify the processing of proposed developments. Criteria for approval of projects which are administered by HUD in the case of federally-uninsured loans are left to the discretion of the State agency; the MHFA determines the economic feasibility of projects and project site selection.

One of the most significant differences between MHFA-assisted programs and those of HUD is that the MHFA is exempt from statutory maximum per unit mortgage limits imposed upon regular HUD programs. This has made for greater flexibility and has allowed housing to be built in high-cost areas.

The HUD administration of the 236 program has been criticized because the processing of applications is cumbersome and time-consuming. The MHFA administration has cut down on the amount of red tape and has been able to process 236-assisted projects with reasonable speed. MHFA processing time is about sixteen months, as compared to HUD's twenty-four to thirty-six months.
The lack of bureaucratization has been a major reason why the MHFA has performed better than HUD. The MHFA has the advantage of comparatively small size; its staff is composed of only fifty people. The executive director directly supervises the four department heads: the head of the mortgage department, which handles site, market and mortgage credit, the head of management, which handles rent-up, marketing and project operations, the legal department head, which examines closing documents, and the head of the accounting department, which handles billing and collection.

The narrow span of control has allowed decisions to be made on the basis of frequent face-to-face communication between those who make and those who implement policy, rather than necessitating the use of written memoes; and this method of decision-making has contributed to the MHFA's large production and effective management of the risks associated with some of its projects. With only a few levels of controls, developers are able to deal directly with those who have decision-making authority. As an independent State agency, the MHFA is able to operate with some administrative flexibility. Its staff has been exempt from such limitations as civil service regulations, competitive bidding, and direct State fiscal controls.

This lack of governmental restraints has permitted the MHFA to hire young and talented employees, many of them under the age of thirty-five. The agency has had an excellent opportunity to attract qualified professionals because both its autonomy and its ability to generate fees have allowed it to pay relatively high salaries.
In avoiding some deficiencies of the 236 program administration, the MHFA has made a particular effort to produce developments of high quality and design. The opportunity to provide attractive and liveable project design has been made available by the relatively low cost of tax-exempt financing available to the MHFA. Interest rates charged to projects by the MHFA have averaged one to two percentage points less than those available through the ordinary HUD programs. In addition, the lack of a rigid mortgage amount per unit ceiling has allowed the MHFA to increase mortgage amounts to the extent that resulting increased costs can be offset by lower interest rates. The net effect has been to emphasize varied dwelling layouts, architectural styles, and amenities such as community and recreational facilities and day care centers.

Emphasis on design is attributable to the MHFA's concern for project economics; as the income of each project's occupants rises, so does the rent. Consequently, unless a project offers particular attractions for persons with the economic means to select their housing freely, such people will leave the project as their economic position improves, thus depriving the project and its neighborhood of valuable social stability, as well as depriving the federal government of an opportunity to reduce its subsidy burdens. There are also projects located in low income or blighted areas where marketing problems exist, even at low 236-subsidized rental rates. For these reasons the MHFA, facing the need for financial self-sufficiency, has found good design and attractive projects essential elements of their programs.
One of the major attributes of the MHFA is its ability to tailor existing programs to the needs of both special population groups and particular kinds of urban areas. Housing for the elderly was a special concern and the MHFA has been successful in fulfilling this need. The MHFA has been an important source of housing for racial minority groups. The MHFA has also been able to structure programs to local and State needs. In addition, the agency has structured its processing procedures in a manner that is efficient for its project volume and average project size, rather than trying to use one procedure for all scales of operation.

The amount of formalized rules and regulations in the MHFA is relatively small. The MHFA has acted like a private lender in most of its dealings. The few formal rules it does have primarily result from requirements regarding subsidies made by HUD or the State Department of Community Affairs. Both of these agencies set income limits on leasing and rent supplement programs.

Overall, its flexibility has enabled the MHFA to be effective. Its lack of rules has allowed it to negotiate with developers to achieve maximal overall social input consistent with financial security. The MHFA negotiates with developers and architects on design. Requirements vary from development to development, depending upon what is marketable and socially desirable.

**Mechanisms against foreclosure**

The problems of financial foreclosure of projects of the MHFA has not occurred. But it must be taken into account that relatively few
MHFA projects have been in occupancy for very long. There are 588 problem dwelling units that are in default with debt service payments three months behind. The principle explanation for the absence of foreclosure in MHFA projects, unlike projects with federal insurance, is that the MHFA must self-insure its mortgages. As a self-insurer of mortgages it holds, the MHFA expends much greater efforts to preserve the economic health of the projects than an ordinary lender might, who can pass problems on to the federal government when trouble arises.

A HUD mortgagor receives both the 236 subsidy and the benefits of HUD mortgage insurance, as we have already seen. The federal government bears the risk of financial failure of any project and the duty of operating or disposing of foreclosed properties. MHFA projects are not insured by the federal government, therefore in the event of foreclosure, the MHFA and the State are responsible.

The respective roles of HUD and the MHFA are different. As a mortgagee, the MHFA must provide its own funds to projects, while as an insurer, HUD insures the funds advanced by other mortgagees. The two organizational roles are similar in that they assume ultimate risk, should a project fail. If a project falls into financial difficulty, the MHFA must either provide its own funds to keep the project afloat or foreclose on the mortgage and sell it for whatever the market will bear. From excess revenue generated ($7,777,000), the MHFA has budgeted a "contingency reserve" for potential loan losses (in the amount of $4,300,000). On a HUD-insured project, once default exists the
mortgagee has the right to make a claim for insurance benefits. Should mortgage payments continually be missed on a HUD-insured development, HUD has to take over the mortgage and reimburse the mortgagee for loss.

The MHFA has used many different financial mechanisms to hold interest costs down and protect its loans. It has set up a "funded replacement reserve" as part of the mortgage to fund the rehabilitation of buildings containing unexpected defects. A reserve for potential loan losses has been provided. The MHFA has kept projects on bond anticipation notes to allow for flexibility for mortgage increases and to fund operating cost deficits for troubled projects. The use of bond anticipation notes rolled over on an annual basis has allowed notes to come on the market at four percent less net interest cost than the long-term bonds, mainly due to their liquidity.

Escrowing

The MHFA has taken steps to assure that tax shelter benefits that are received by private owners of housing projects contribute to the fiscal soundness of the projects. The tax benefits, as explained in Chapter One are important incentives to private developers to participate in subsidized housing projects. The capital contribution made by investors is left available for use in the project to meet unexpected expenses, until such time as the MHFA has issued its Certificate of Approval and acceptance of the completed project. The MHFA requires developers to be responsible for meeting any operational deficits due to increases in taxes or operational expenses. Security comes from a
letter of credit for the first three years of operation to cover defi-
cits. This greater security provided to the development protects
investors against their most severe risk, that of recapture of depre-
ciation by the Internal Revenue Service, in the event of foreclosure.
Another requirement that the MHFA imposes regarding the sale of tax
shelter benefits by developers is the prohibition of use of the manage-
ment fee as collateral for payment of cash dividends. Even though cash
dividends constitute only a small fraction of the full return going to
investors, developers customarily have subordinated the management fee
to guarantee their payment. The result is insufficient funds available
to pay for competent management, and additional pressure by management
to raise rents. The prohibition against subordination of the manage-
ment fee facilitates the creation of an adequate management budget,
especially for troubled projects.10

The MHFA has also required developers to secure an agreement with
local assessing offices that tax assessments be based upon percentages
of gross rents. This tax formula makes rent increases less volatile.
If an agreement cannot be reached, the MHFA requires an escrow account
as a guarantee against the need for a rent increase based upon tax
increases. Since the major risks faced by investors are in the early
years of a project, these and other requirements add security to the
project and make it a sounder investment.

Conclusion

The experience of the MHFA, gained by being intimately involved in
a larger number of developments of a similar type than any individual
developer, allows it to reduce normal development risks by anticipating and avoiding problems that might otherwise occur. MHFA involvement in the development process insures that the development finances serves the public goals of the agency. Its involvement has reduced risk and has ensured that public interests will be better served.
Chapter Five

THE DEVELOPMENT PROCESS UNDER
THE MASSACHUSETTS HOUSING FINANCE AGENCY PROGRAM

During the development/management process under the Massachusetts Housing Finance Agency (MHFA), careful attention is given to the long-term viability of developments. In this Chapter we will discuss what mechanisms it employs to achieve long-term viability, starting with the initial development of the site and development team review stage, then proceeding to design and construction, and then to management. Finally, we will discuss proposed and already-implemented methods for dealing with increased operating costs of multi-family housing developments under the MHFA.

Site and Development Team Review

In an effort to ensure the financial success of a development, the MHFA is particularly looking for sites that have the ability to attract market-rent tenants. Such sites allow the MHFA to create mixed-income housing. "Past experience of public-assisted housing shows that the concentration of low income persons and families in standard structures built with public subsidies does not eliminate undesirable social conditions." Through the mixed income approach, the production of housing is both economically and socially successful.

The initial stage starts with preliminary submission of necessary site information. The site inspector goes out to the site and reports
on neighborhood facilities, physical characteristics, environmental hazards, etc.

After the site inspection, the preliminary application is reviewed by the entire MHFA staff from all departments together. The site inspector presents his findings to all departmental personnel, who provide input and criticism on the development team's experience and competence, on the site's ability to support market rental units, and on the proposed unit mix for the site. Information about the site's market area is compared with similar conventional multi-family housing units built in the past five years. Examples of the kinds of information reviewed are vacancy levels by bedroom type, the elimination of housing in the area, low income need for housing in the area, population trends, income levels, economic condition of the area, etc.

Participation at this meeting of the entire staff allows many different sources of potential problems in the development/management process to be pointed out. The staff itself obtains a broad understanding of the proposed development and the development team. The meeting makes clearer what potential tradeoffs might allow for a viable project at an early stage, and permits the MHFA to be aware of and deal with all aspects of the development process.

At the staff meeting a decision is made as to whether to entertain the application for the proposed project. Denial of an application may result from an unsuitable site, development team, or both. The proposed density and unit numbers may also be unacceptable. There is an appeal process by which a resubmission of the preliminary application-
tion can be accepted if the deficiencies have been remedied. If the
development seems worth considering, the developer is introduced to the
mortgage officer who will have to approve the application from the
point of view of financial viability, and to the design and management
officer who will have to approve the application according to the cri-
teria established by his office.

Feasibility and Financing

In its review of financial feasibility, the MHFA performs certain
critical analyses on a proposed development to insure its viability.

An application for mortgage financing begins with full economic
information about the projects, including estimated income, operating
expenses, fixed expenses, and the estimated development cost of the
project. Usually the MHFA mortgage analyst works with the developer
on the application.

Feasibility focuses on operating costs first. Operating and
management budgets are reviewed carefully and are set at realistic
levels. Figures on operating costs are based on actual figures from
current MHFA developments in the area. The MHFA management staff are
involved in setting these figures, based on the most recent data avai-
lable. Operating costs vary, depending on the unit density mix, neighbor-
hood characteristics, and the type of development planned. The
projected operational figures take into account inflation to ensure
realistic operational expenses figures and long-term viability of the
project.
Next, site acquisition costs are compared with those of other sites that have been sold in the area recently. If there are unusual site problems, the cost for remedying them is deducted from the price of the site to keep this expenditure from having to be absorbed by the development. The MHFA uses its negotiation leverage with the developer to obtain a site acquisition cost that the project can support.

The type of housing being developed, which attracts high and middle income tenants, gives the MHFA the ability to pay more to obtain attractive sites and to lower the density of a development. This higher site cost is able to be absorbed because the potential tenants have the capacity to pay for it. HUD 236 developments on the other hand are economically homogeneous, with low and moderate income tenants; their rental revenues cannot absorb a higher cost site.

The feasibility analysis includes a "built-in cushion" for higher than expected interest rates. The lending rate charged to the developer is half a percentage point more than the MHFA's borrowing rate. The MHFA uses a debt service constant that reflects the estimated lending interest rate to the mortgagor. The debt service constant is rounded up to the nearest quarter point as a contingency, in case the MHFA's borrowing rate on the bond market should be higher than expected. This debt service constant, with the added contingency, is used in the MHFA's calculation for the feasibility of the development. If the actual bond financing comes in as estimated, money from the contingency fund may be used as extra operating funds or to lower rents.

Currently under the Section 8 housing allowance program, the MHFA provides another financial cushion for proposed developments by requi-
ring all developments to be at maximum fair market levels set by HUD, with excess revenue subsidies placed in operating budgets to insure against possible future escalation of costs. 5

Design and Construction

To ensure attractive and competitive developments, the MHFA design and amenities levels are equal to or exceed conventional apartment levels. Examples of these design and amenities levels are seen in Figure 3.

During the design phase, if the MHFA feels that the architect does not have the qualifications to design or construct quality housing, it may require the developer's architect to associate himself with an architect possessing these qualifications. The MHFA has not set any formal minimum standard on its design criteria, because it feels that such a minimum would be used as maximums by architects. This would restrict the quality of design. 6

Designed into many MHFA developments is a high level of security, which has helped many projects' long-run operations. Security screens have been placed on first story windows on many developments, for example. The requirement of a high level of security has been especially helpful to maintain livability and stability in developments located in high crime areas.

The MHFA construction field inspectors participate actively during the construction phase. There are weekly meetings with representatives of the owner, architect, contractor, and any major subcontractors of
the MHFA to go over the process of construction. The intensity of these inspections enable small problems to be caught before they become major ones. MHFA field inspectors have power over the disbursment of funds and can hold up funds, demanding that deficiencies be remedied, before allowing disbursment.

As mentioned previously, the MHFA requires the escrowing of syndication proceeds until project completion. Thus, profits from syndication are available as security that can be drawn if there are serious cost overruns or other financial problems. Because of this escrowing developers are hesitant to agree on a construction budget which may be unrealistically low, since resulting overruns mean possible elimination of their profits. This profit-withholding has been an effective incentive to developers to meet their construction budgets.

Escrowing, however, does not preclude the MHFA from granting mortgage increases during construction to cover unexpected and justifiable cost overruns. Part of the MHFA's success in avoiding financial foreclosure during construction has been due to its ability to act quickly and supply necessary funds to prevent delays. Since construction financing is on short-term notes, mortgage increases can be easily arranged. Decisions are made quickly when mortgage increases are asked for.

MHFA staff have been involved in trying to resolve problems among general contractors and subcontractors, and have served as mediators in settling disputes. This has prevented possible delays from legal proceedings, which may go forward if disputes are not settled quickly.
For example, the MHFA has moved to insure disbursments of funds to subcontractors who have not been getting paid. This has kept them on the job and averted possible walk-outs.

The MHFA's involvement has been with the commitment to solve problems; this problem-oriented approach has been the basis of the Agency's success.

**Management**

A crucial element in long-term project viability is the great amount of effort expended by MHFA staff persons during the start-up phase of a development. In the following section we will discuss the extent of the MHFA's involvement in all aspects of the management phase.

**Marketing**

During the tenant selection process, funds have been provided for marketing to insure a large pool of possible tenants from which to choose. HUD's 236 program, by comparison, does not provide for this marketing expense. But this expense, provided for in the mortgage, is important because it enables the project to attract tenants of varying incomes. Enough funds are provided for a strong marketing effort to be pursued. This has helped to facilitate quick rent-ups, attract market-rate tenants, and to promote economic integration for a viable project.

To insure quick rent-ups, comprehensive and community-wide advertising is required two weeks before rent-up begins. A furnished apart-
ment model is also required to have been set up at the site prior to rent-up.

Tenant selection

The MHFA approves all tenants before their occupancy to insure that economic integration is obtained. The MHFA reviews applicants with the site management staff to be sure of eligibility and, more importantly, that tenants can economically afford the rent levels of their units. The need priorities and screening selection criteria of tenants are shown in Figure 4. The selection process is conducted as equitably as possible, with criteria for selection being made clear to both the applicants and the rental agency. Rights for appeal of a decision are explained; an applicant's case can be heard by an MHFA staff person. Throughout the process the MHFA has the ultimate decision-making power.

Tenant-Management Relations

It has been the MHFA's policy to establish good communication with tenants and its development's management staff. Prevention of alienation through good tenant-management relations has resulted in, in many cases, obtaining good housing services with lower operating costs, which is beneficial to all parties concerned.

Tenants are given a pre-occupancy orientation and a handbook to educate them about the proper care of their apartments. The proper use of appliances and facilities of the development, the rights of both the
management and residents, and the rules and regulations of the complex are explained.  

Many existing lease agreements only define the obligations of tenants and never those of landlords. Such agreements often are hard to understand and reflect only the owners' interest, with little regard to that of tenants. The MHFA "occupancy lease" is much more concerned with the rights and obligations of both parties. For example, this agreement requires the management to make necessary repairs within seventy-two hours of a request to do so. It allows rent increases only once a year and only after twelve months of occupancy by the tenant. On the landlord's side, however, there is strict enforcement of regulations that are set down, especially regarding the payment of rents. In developments where the cushion for revenue loss is very small, nonpayment of rents can easily put projects in a deficit position. Management has ordered eviction of tenants for nonpayment of rent fourteen days after it has been due. There is no right of appeal of eviction, if there has been nonpayment of rent. However, this provision does not mean management may obtain rents no matter what the quality of their management services. For, if the MHFA concludes that the management has failed to remedy defects not caused by the resident which are injurious to life, health, or safety, tenants may abate rents.

Because of clearly defined rules and responsibilities for tenants and management, tenants have a strong incentive to complain to management about maintenance problems, without fear of retaliatory eviction or rent increases. Likewise, the management has a strong incentive to
act on these problems quickly. Such actions maintain the quality of a development and its desirability as a place to live, and thus protects the MHFA's investment.

To increase livability and to foster better communication among tenants and management, social programs for tenants have been encouraged by the MHFA. These range from free summer concerts to weekly beano and card parties. To assist tenants during certain hardships, such as financial difficulties, management has made referrals of tenants to community agencies. This has been done to prevent involuntary termination of leases because of nonpayment of rent, and thus has helped maintain the stability of the development.11

In general, the MHFA staff has taken an aggressive role in fostering a strongly interdependent sense of rights and responsibilities between tenants and landlords. The management staff actively visits developments to make an assessment of the quality of maintenance and to question tenants about how well their management is responding to their needs. This "hands on" treatment is in contrast to HUD's policy, in which written reports from the management agent are used as the main instrument for management monitoring of projects.

In order to allow for better response to tenants' needs, on-site management is given a high amount of autonomy and responsibility. Expenditures of up to $500.00 for labor and/or materials in connection with the maintenance of a project do not need the owner's approval. In core city developments where maintenance needs are higher than normal, more maintenance personnel are provided. Understaffed developments
suffer from a higher than normal frequency of repair needs, which has resulted in breakdowns in maintenance quality. Overworked maintenance personnel have quit in frustration, which has resulted in high staff turnover and has increased inefficiencies because of the training required for new replacements. Ineffectiveness due to understaffing, then, has led to the deterioration in the quality of maintenance. Tenants' attitudes about the property are also affected. If the management fails to provide adequate maintenance services, tenants are not concerned with the upkeep of the buildings and are even encouraged to deliberately vandalize them. Hiring the necessary personnel to provide adequate maintenance ensures the livability and stability of the development.

One of the major reasons why the MHFA has been able to meet expenditures with revenues generated is the speed by which rent increases are approved. The MHFA processes rent increase applications within thirty days of their submission. Rent increases are evaluated according to documented expenses from the previous two years and estimates of the projected annual budget. Increases are granted for the purpose of meeting projected expenses. HUD is slow to grant rent increases and the amounts of increases are based on previously incurred expenses only, and not on projected future costs. For the MHFA, however, rent increases have given them the opportunity to review closely the financial position of a development and to find out if there may be a management deficiency that has resulted in unnecessary expenditures. Sometimes an MHFA staff person has encouraged owners to ask for rent in-
creases, even though they did not have this intention. The MHFA's quick response in processing rent increase applications has prevented the deterioration of maintenance and other housing services.

The MHFA, on the one hand, is more aggressive than HUD in pursuing tenants' grievances. On the other hand, it is also more aggressive in supporting the landlords' legitimate demands and needs, such as timely rent increases. What is critical to the MHFA's ability to perform to both tenants and landlords is the Agency's nonbureaucratic capacity to respond quickly to emerging landlord/tenant situations before they balloon into crises.

**Dealing with Increased Operating Costs**

In this last section of the chapter we will examine the methods proposed and currently used by the MHFA in dealing with increased operating costs, and why the MHFA has better capacity than HUD to absorb them. We will look at potential options for dealing with such increases and their ramifications as they relate to tenants.

Increases in operating costs, taxes and utilities, are critical problems faced by the MHFA. The MHFA has been able to handle these problems in part because the presence of market income tenants provides some latitude for rent increases, a latitude not found in totally subsidized housing such as HUD's 236 developments. However, rents cannot be raised indefinitely even with market tenants; and eventually the two most serious elements in operating costs - utilities and taxes - must be attacked.
In 1974, when utilities and operating costs escalated from original estimates, the MHFA did an analysis of these increases. Their findings show that utilities costs represented a major portion of operational costs for developments. Among the twenty developments investigated, per unit cost of utilities ranged from $288.00 to $669.00 per unit per year. The cost analysis of the twenty development budgets is shown in Figure 5.

Energy costs are not the only budget item that has dramatically increased. There has been a dramatic increase in payroll expenses also, and, in some cases, in taxes. In most cases, however, the increases in utility and fuel costs represent the largest dollar increase in the expenses of the developments examined.

The MHFA undertakes actions to better control developmental expense by allowing a fixed management fee only, instead of a fee based on a percentage of gross rents. This has served two purposes: first, management fees do not necessarily increase with an increase in utilities rates when there is no extra management effort called for; second, if management implements a program of lowering operating costs, it does not suffer a reduction in its fee for initiating this savings. In addition, a fixed structure prevents twenty percent of every rental dollar from being used for increases in the management fee and for increases in taxes, where these are based on a certain percentage of gross rents.

In an effort to control utility costs, the MHFA has placed check meters in existing developments where there have been high utility costs.
Expenses for these check meters, $150.00 to $350.00 per unit, have been funded through mortgage increases. When tenants review their lease agreements, the amended agreement will have a maximum monthly kilowatt usage included in the rent. Usage above that amount is charged to the tenants by the management. Since 1975, new developments have been required to have check meters. Under a check meter system, the billing continues to be master metered, but a check meter is tied into each household line. Employees of the management agency record meter readings to judge whether there is substantial variation in utility usage among tenants.

The check meter approach, it is hoped, will prevent tenant abuse in the use of utilities. When a check meter system is used management can educate high users in utility conservation measures, or a single maximum usage may be included in the rent, with the tenant being billed by the management for additional usage.

The check meter approach has the advantage of not automatically throwing the whole burden of utility costs directly on tenants. It also allows tenants who are careful to avoid utility surcharges. The disadvantage of this approach is that its administration may be complex to undertake and difficult to enforce.

The MHFA had considered turning full responsibility for paying utilities costs over to individual residents, with apartments being separately metered, but decided that this would put an unfair burden on some tenants. This is the typical means of metering of electricity in conventional apartment housing. Such a pattern would substantially
relieve the operating budgets of developments, but would also place the burden of utility costs directly on tenants, regardless of their ability to pay. (HUD has allowed such a pass-through of utilities with credit to the tenants in the form of reduced rents collected. Under the 1974 housing law it is possible for 236 developments to charge rent without including utilities, but adding a utility allowance set down by HUD that brings the rent down to not less than twenty percent of a tenant's income.)

Housing authorities in Massachusetts have operated the Rental Assistance Program using a system in which tenants pay twenty percent of their adjusted income plus utilities. According to the Cape Cod and Island Tenants Council, this set-up can mean that tenants who are heating with electricity can end up paying as much as four times their rent for utility costs during the winter months. The Rental Assistance Program experience demonstrates the disaster that can accompany tenants responsibility for utility costs.

Several housing authorities have operated with a pass-through electricity system, with tenants having individual responsibility for payment of utilities in conventional public housing. Utility costs generally run between $25.00 and $35.00 per apartment (for two and three bedroom units). For low income tenants, paying full utility costs can mean an actual increase in rent of fifty percent or more, which can put serious burdens on them. Currently utility companies also charge security deposits to consumers that add to the financial burden of the tenant.
However, there are also positive benefits to low and moderate income tenants as a result of passing-through utility costs. If the rent is reduced when tenants take responsibility for the payment of utility costs, there is a simultaneous reduction of operating costs because of the reduction in the management fee. There is also a reduction in taxes if there is a 121A tax agreement.

Recognizing that increases in utility costs are a problem, HUD has redefined what is included in the basic rental charge. Under the 236 program, the "basic rental charge and the fair market rental charge may be determined on the basis of operating the project without the payment of the cost of utility services used by such dwelling units." If also allows the rental of such units at less than twenty-five percent of a tenant's income "as the Secretary's determination represents a proportionate decrease for utility charges to be paid by such tenants, but in no case shall such rental be lower than twenty percent of a tenant's income."

The 1974 Housing Act also allows HUD to pay an operating subsidy for 236 developments in an amount which represents the increase in the cost of utilities and taxes over and above the amount budgeted in the original operating budget. This program has not yet been implemented.

Under many tax agreements, particularly under 121A agreements, property taxes are based on a percentage of gross rents collected. Since utilities costs are included in the rents, property taxes have increased as utilities costs have increased. In finding methods to lower taxes, the MHFA is currently attempting to develop a procedure by
which utility costs are reflected as a separate charge to tenants and taxes are charged on the basis of rents alone.

Another method by which the MHFA is trying to reduce utility costs is energy conservation. Programs are being set up to train residents in the use of equipment, to install timers, to cut wattage on lights, etc. The MHFA is also presently installing into some of its developments computer-regulated heating systems. The computer control system automatically regulates heat, depending on when it is needed. The regulation is patterned to follow the living habits of tenants. In laundry rooms, the MHFA has required timers on lights, which automatically shut off after a fifteen minute period.

The MHFA has also obtained lower cost rates for utilities. This has been accomplished by switching over to a single electric meter system which allows projects to be billed at a lower "bulk rate" for electricity. The MHFA has encouraged owners to actively bargain with utility companies to obtain lower rates.

Another area where there is a wide variety of costs is in insurance. The MHFA is exploring the possibility of purchasing blanket insurance that would be available to all developments. A blanket insurance premium would give the MHFA enough leverage to reduce insurance cost, particularly in hard-pressed inner-city developments where insurance costs are high. 21
Chapter Six

DEALING WITH FINANCIALLY TROUBLED PROJECTS UNDER THE MHFA

Early-Warning Signals in Problem Developments

Problems which have led to default may be difficult to detect. Default occurs when obligations under the mortgage are not met with adequately. Such failures can range from non-payment of debt to management neglect. Detection of problems leading to default is used as an "early-warning" system by the MHFA, so that proper action can be taken before problems develop into major ones.

Developers have been reluctant to come forward to the MHFA to indicate that problems exist in developments. Many developers try to hide problems for fear of retaliation or even foreclosure by the MHFA. This has resulted in unnecessary delays of disbursements from funded replacement reserves to which developments were entitled all along. It has also resulted in delays in applying necessary subsidies to developments. Early detection of problems allows the MHFA to work closely with developers to find effective solutions.

A reason why problems are hidden is the identification of interest between the contractor and the management. Defects in construction must be remedied and the cost of such remedies must be absorbed by the contractor. These costs reduce the builder's profit. Since the builder and the management agent are one and the same, it is not in this party's interest to report defects during early operation of
a development when all the profits have yet to be collected.

An early warning sign of problems in projects under construction is indicated by developers not drawing funds from their construction accounts. This situation may indicate that work has stopped on the site, due to disputes. Problems are also pointed out in reports from MHFA construction field inspectors.

During operation of projects, early warning signs of trouble are apparent in a lack of maintenance (e.g., unkempt public areas, unattended to repairs, etc.), high levels of vacancies and rental arrears, dissatisfaction of residents, etc. These problems may indicate that insufficient funds are being generated, and certain operating expenses are not being paid. Such signs may lead to legal claims from creditors or tax liens on the property. These problems can threaten the operation of the development; utilities may be turned off because of nonpayment, thereby making the development uninhabitable.

In an attempt to formulate a system to better flag problems in developments, the MHFA requires tax payments to be directly contributed to its office. Previously, the MHFA has required escrowing of revenues for the purpose of paying property taxes, but payments have not always been kept up by developers and insufficient funds have been discovered at the time when taxes had to be paid. The MHFA is now implementing a requirement which instructs developers to submit funds monthly to the MHFA for the payment of these taxes. It is hoped that this will enable the MHFA to more closely monitor the financial status of its developments. Nonpayment to this tax reserve will permit immediate investigation into a project's finances by the MHFA, and so
catch problems at an early stage.

For most MHFA developments, 121A tax agreements are not signed and are not legally binding. This has resulted in unpredictable tax increases that existing rent revenues are unable to keep pace with. The MHFA is attempting to cooperate with the Department of Corporation and Taxation to make available tax figures on developments, in order to enable the MHFA and the developers to make the necessary adjustments in rents.

Yet sometimes the early-warning system is not sufficient to catch a development before it gets into financial trouble. When such is the case, that is, when a project falls into or nearly into default, the MHFA has several options available to it. The MHFA has essentially three alternative courses of action once a project falls into default: 1) do nothing, 2) foreclose, and 3) implement a workout. Each has a set of consequences and ramifications, discussed below.

MHFA Alternatives in Default Situations

1) Do nothing: this alternative ultimately lessens the development's physical viability as well as its financial viability. It usually results in the next alternative, foreclosure.

2) Foreclosure: when this action is taken, the MHFA will probably not be able to sell the development for the amount of mortgage indebtedness. If the project mortgage falls into default and the mortgage is foreclosed, the investors lose their interests in the project and face
a taxable gain on the foreclosure sale, because the unpaid balance of
the mortgage is deemed to be the amount for which the partnership sold
the property. This amount usually exceeds the partnership basis for
the property after construction losses and accelerated depreciation
have been taken into account. (In such a case, then, the investor has
a taxable gain on which income tax is due, as a result of a foreclosure
with no cash received and with the investors obliged to pay taxes.)
To date, the MHFA has not foreclosed on any of its workout negotiations.
Thus the MHFA chooses foreclosure only if there is no other productive
alternative.

There are, however, advantages to foreclosure. All project in-
debtedness to outside parties, except real estate taxes, is wiped out.
The MHFA is rid of an owner/manager that is unable to resolve the pro-
blems of the development, and obtains complete control over the project.
When the development is sold, a "problem development" becomes the res-
ponsibility of another party.

As the MHFA has not yet employed foreclosure, implementation of it
may add credibility to the MHFA's negotiation position. At present,
developers under an MHFA program are sceptical that the Agency will
ever foreclose, and threats of foreclosure have not been treated seri-
ously. Although an actual foreclosure would certainly alter this at-
titude, it would, of course, also affect the financial confidence of
bond holders in the MHFA.2

Foreclosure can adversely affect the MHFA's financial stability,
because the Agency must rely on the sale of bonds to finance future
housing developments. Since the bonds are supported by payments on the mortgages of the projects built with the proceeds, a series of foreclosures on earlier mortgages impairs earlier bond issues and has a serious effect on the saleability of future bonds.

There are drawbacks to foreclosure which make a workout situation more desirable. Foreclosing is time-consuming and the time period for transfer of the title can allow for deterioration of a development. Prior to resale, a receiver must be appointed for the development to insure that rental income is not diverted. In addition, legal and other fees must be paid. The added deterioration tends to lower the possible sales price on a foreclosure sale, thus increasing the MHFA's losses.

Foreclosure sales have usually resulted in a sale price that is less than the outstanding mortgage. HUD's foreclosure sales have averaged fifty cents on the dollar. The difference between the outstanding mortgage amount and the sale price would have to be made up by MHFA loan reserves. These reserves could then dissipate rapidly. Also, sale on the open market to a private owner would result in the loss of subsidies and ultimate eviction of tenants who are unable to pay higher rents. This could lead to political as well as social problems.

Foreclosure should be used only when major deterioration which threatens the security of the mortgage is occurring and when, at the same time, the owner is not working in good faith with the MHFA to resolve the situation.
3) Workout: through a workout, the overall economic and possible political and social ramifications of foreclosure can be averted. A workout is the formulation of a financial plan to avert foreclosure and continue operation under the existing mortgagor. Limited partner investors are concerned about keeping a subsidized project away from foreclosure because of the serious tax consequences to them of foreclosure. Thus there is a great financial incentive for all parties to negotiate a workout.

MHFA Leverage in Workout Negotiations

The MHFA can take advantage of the situation in regard to foreclosure and limited partner investors, as described above. The Agency can demand certain changes and concessions from the limited partners. Conditions under which the MHFA could agree to a workout arrangement may include a change of general partners, and a cash contribution from the partnership to fund deficits. Such moves have resulted in obtaining new limited partners in the partnership to raise funds, in which forty-nine percent of the interest can be transferred to new limited partner investors, without the consequence of the transfer being defined as a sale that may generate a tax liability. Thus the partnership is kept alive without the tax problems of foreclosure, and the funds from the new limited partners are used in the development to offset deficits. If the nature of repairs is such that it does not prolong the life of the development, the cash contribution for repairs may be deducted as an expense in that year. This and other workout factors will be discussed further later.
Another one of the tactics the MHFA has used to influence managers and developers to work cooperatively to resolve problems is the threat that the Agency will not do business with them in the future. At a time when financial institutions are not lending money for multi-family housing, the MHFA is virtually the "only game in town". Management firms would like to cooperate as fully as possible, because they do not want to be in the MHFA's bad graces.

Using its leverage, the MHFA has attempted to remove an undesirable general partner from its developments. The establishment of a procedure by which to remove a general partner or partners has been a problem for the MHFA. In general, developers stubbornly resist a takeover unless they can protect their tax and financial positions. A general partner may not want to leave if he has a great deal to lose in a development, either in terms of money invested, tax benefits, equity that would be raised through refinancing, or undistributed investment capital from limited partners. But if an existing general partner decides to drop out, he is relieved of all unsecured debts on the property, for which the MHFA and new general partner or partners must supply funds.

A new general partner would be desirous of replacing another in a troubled development for the same reasons the original partner does not want to drop out: to take advantage of syndication proceeds that have yet to be disbursed and the possible equity the project may represent. Getting a general partner out and a new one in is a complex and time-consuming political as well as legal process; but it may be a critical element in rescuing a development from foreclosure.
are, however, a number of "workout elements" which the MHFA can employ short of replacing a general partner. Those elements are critical to an understanding of the range of options available to the MHFA when it tries to orchestrate a successful workout package.

**Workout Elements**

There are a variety of forms of relief by which additional funds may be made available to a troubled development. The MHFA can defer payment of funds into the replacement reserve in order to allow other expenses to be paid. Management fees can be lowered when it is felt that those fees are rising excessively in response to other rising costs. The payroll is vigilantly examined to see whether there are excess personnel.

A mortgage increase due to increased capital costs is automatically subsidized through the 236 interest subsidy existing on the mortgage. A mortgage increase can eliminate operating deficits in a "one-shot" manner. Funds from the mortgage can immediately eliminate, for example, tax liens and pay bills, so that critical utility services can continue uninterrupted. By funding through the mortgage funded deficits, payments are spread over the life of the mortgage. The increase in rents through this method is lower than if deficits were directly made up out of rent increases; thus this strategy is helpful to developments with tenants who are already financially overburdened.

If more financial relief is needed, deferment of a part of the debt service can be implemented. For developments that are on bond anticipation notes, which are short-term financing instruments, interest
may be deferred and accrued. This method of relief has been implemented in new developments that have rent-up difficulties. It is thought by the MHFA that all new developments might be given a six month debt service deferment period during initial rent-up. This would enable developments to become financially stable and generate sufficient revenues before debt service is paid. Interest that is accrued during deferment would be included in the mortgage.

If a development is already on permanent financing, both interest and principal can be deferred. Deferment results in an increase in debt service payments for the remainder of the mortgage term. The following example gives a concrete illustration of the way in which the MHFA structures a workout situation in a particular troubled development.

Workout Example

Projects in central city areas have been a problem for the MHFA. Scattered rehabilitation developments in Boston's Roxbury area have experienced higher than average operational costs. And because these developments are scattered, it has been more costly to manage them.

In a particular development in Roxbury, there have been problems with tenant selection. The development initially experienced improper tenant selection, which has resulted in a too high concentration of low income families. Unqualified tenants were chosen for the moderate income units, for which they had insufficient financial resources. This has resulted in high rent arrearages. Revenues
were not adequate to allow proper maintenance, and this lack caused
vacancies to increase.

This particular development has suffered a high amount of physi-
cal deterioration of public areas. The lack of open space in the
neighborhood and the limited living space within apartments have
caused hallways to become play areas, resulting in more wear and tear
on the property.

To help relieve some of the financial pressures on this develop-
ment, electrical heating systems, which have worked inefficiently and
are expensive to run, will be replaced by a gas system that will re-
sult in lower fuel bills. A mortgage increase of $12,000 per apart-
ment has been allocated. Eight thousand dollars will be spent for
physical improvements such as roofing, security windows, intercoms,
and the new heating system. The remainder will be used for unpaid
debt service. Rent supplement subsidies will be added to support the
mortgage increase.

Also, the existing general partners will be replaced. The new
replacement has extensive holdings in the area, and has an in-house
management and maintenance staff to service the development. He will
be able to consolidate and better manage the development efficiently,
which should lead to reduced operational costs.

The MHFA is assisting the new general partner in negotiating with
the Boston Redevelopment Agency and the Office of Mayor Kevin White to
supply necessary infrastructure improvements in the neighborhood. The
MHFA is negotiating the release for rehabilitation of abandoned build-
dings next to the development, held by the City. Vacant lots owned by the City are being sought to provide necessary parking facilities and open space, to relieve congestion and to improve the neighborhood's liveability.

As we see above, the MHFA has taken a very active role in the work-out process. It has also taken the leadership role in influencing other city agencies to commit resources to neighborhoods where MHFA developments are located.
In an attempt to find ways to deal with default more effectively and to avert foreclosure, we will discuss in this chapter financial mechanisms and existing tax laws as they pertain to a workout solution. A workout is the formulation or development of a financial plan between the mortgagee and the mortgagor whereby foreclosure is averted. The mortgage loan is put on a workout basis, in which borrowers are given additional time and opportunity to work out of their financial difficulties and repay the outstanding debts as the workout program, imposed with the consent and cooperation of the borrowers, permits. Through the workout option provided by the MHFA or HUD, both the lender and the defaulting borrower evaluate the economic viability and operational cash flow potential of the property to determine a financial plan so that the mortgage of a property can be reinstated. The financial plan may include the addition of capital from the development's investors to make improvements necessitated by deferred maintenance, etc. Raising capital for improvements is a complex process involving a variety of trade-offs - financial and legal. The process of negotiating a workout must be examined in light of the following elements: 1) partnership format, 2) tax consequences to investors upon foreclosure, 3) limited partner participation in the workout, 4) forbearance and its tax implications, and 5) repairs and their tax consequences.
Partnership Format

Some partnership agreements provide for the forced withdrawal of a general partner and replacement by a new general partner if certain conditions are not met by the original general partner. But usually the general partner, often the sponsor or packager, has considerable leverage over the investors by virtue of his position as both legal and actual manager of the partnership's affairs. Even though the partnership agreement may provide the investors with the power to oust the general partner, without complex negotiation it may be extremely difficult for the investors to force the general partner to withdraw. Replacement of general partners is not a simple matter. And resistance to removal can delay the implementation of a workout plan.  

General Partner's Liabilities

The stated obligation of general partners to insure viability of a project may or may not be honored. To insure the viability of a project, the general partner often agrees to fund certain deficits of the project for a period of time. In other cases, the limited partner investor's capital contribution is staggered over several years during operation to insure that a project remains free from default. But there are also cases in which a syndicator and a builder are general partners and are in serious financial difficulties, and may not be in a position or may not be willing to pay these deficits.
It should be noted that there are limits to the liability of the general partner. There are provisions within the partnership agreement that indemnify general partners from liabilities for any act performed by themselves that is within the scope of the agreement, except for acts of malfeasance, gross negligence, or misrepresentation.

Since the general partners are in full authority and control of projects, it is difficult to enforce the legitimate claims of the limited partners. Even though the standard agreement has provisions for the removal of a general partner, enforcement is difficult. Thus, when a project is in financial trouble that may lead to foreclosure and limited partner investors want to make general partners live up to their obligations (that is, pay project deficits, improve management services); the limited partners must consider three things: 1) the general partners have full management authority, 2) there will be significant costs for litigation of all claims against general partners, and 3) if the investors lose and the project is foreclosed, their tax liability may be substantial.

A close analysis of the above factors may provide insights into the investors' action or failure to act with respect to a workout. Because it is so difficult for limited partner investors to enforce claims against general partners, it is equally difficult for them to force general partners into planning and carrying out a workout, or to avoid foreclosure. However, claims against general partners are of value to HUD or the MHFA only if the limited partners are able to get cash from the general partners and continue their interest in the pro-
ject; and the general partners are willing to use some of the money to revitalize the project.

Tax Consequences to Investors upon Foreclosure

Investors in Section 236 limited dividend projects view their investments in terms of cash benefits derived from income tax savings, rather than benefits from the six percent return on equity from operational cash flow, or the mortgage refinancing potential after twenty years. A financially troubled development that is foreclosed becomes a potential income tax liability for the investors and makes for a loss of future tax benefits. Because of these adverse effects from foreclosure, investors have great motivation to participate in a workout.

The difference in price among 236 projects is important in evaluating the investors' tax and financial position in relation to foreclosure. The greater the cash investment as a proportion of the mortgage, the greater the likelihood of a tax liability if foreclosure takes place during the early years of operation. The less the investors paid to acquire the project, the shorter the period of operation required for him to break even before foreclosure occurs.4

In most situations, a syndication sells ninety-five percent or more of the tax shelter to limited partner investors by the twentieth year of project operation. Toward the last two to five years of the twenty year period, the project's mortgage amortization exceeds available depreciation deductions, and thus becomes a tax liability.5 However, developers with an optimistic view of potential sale can retain up to
fifty percent of the proceeds from a sale; or the developers can retain up to fifty percent of the proceeds from refinancing after twenty years of project operation; or developers can also retain a lion's share of any cash flow after a given number of years.

The tax consequences of foreclosure to a hypothetical investor who owns a percentage interest in a limited partnership are dependent on 1) the income tax bracket of the investor, 2) the time when foreclosure occurred, 3) the project type (i.e., rehab vs. new construction), 4) the amount of total investment, and 5) the amount of depreciation taken by the investor.

In Figures 6 and 7, two hypothetical projects with mortgages of $1,350,000 and $3,150,000, respectively, are operated for different lengths of time before foreclosure takes place. Figures 6 and 7 show the financial tax liability which results upon foreclosure at years two, five, and eight of operation, for investors with twelve, fifteen, and eighteen percent of the mortgage as their capital investments. The consequences for different investors are shown for those in fifty, sixty, and seventy percent tax brackets.

It is safe to assume that the more the investors have to lose from a foreclosure, the harder they will try to avoid it. Even though investors have received prior tax benefits, which may have effectively returned their investments, they still want to avoid foreclosure because of the impending tax burden.

The longer the project has operated, the greater is the tax burden of foreclosure. The tax burden upon foreclosure after five years
of operation is twice that produced after only two years of project operation (see Figure 6). The tax burden upon foreclosure increases through the eighth year. After the eighth year of operation and onward, the tax burden increases are not materially greater.

On the other hand, the longer the project operates before foreclosure, the greater the gain to investors from tax shelters derived from depreciation deductions. At the same time, the longer a project has been operating before foreclosure or sale, the larger becomes the proportion of the gain that is taxed at lower capital gains rates; while the smaller becomes the proportion of the gain that is taxed at higher income tax rates.

The tax bracket of investors is the significant factor in a consideration of the effects of foreclosure. Figure indicates that investors in the seventy percent tax bracket who invest in a project for five years are close to breaking even after including the tax burden of foreclosure; and after eight years these investors make a profit after foreclosure. Investors in the fifty percent tax bracket, however, are still in a substantial loss position upon foreclosure after eight years of project operation.

The tax liability resulting from a foreclosure is an important incentive to investors to justify putting additional cash into a project. The contribution of cash may be the necessary condition to produce a workout arrangement that allows the project to continue to operate for a period sufficient to permit investors to recoup their original cash investments. The tax consequences of adding more part-
ners is also a consideration. When more funds are needed to help a financially troubled development, new capital is sought via the admission of new investors in the partnership, or through capital contributions from existing investors. It is important to consider Section 708 (b) of the Internal Revenue Code concerning admission of new investors. This Section provides that if fifty percent of the interest in capital and profits is sold or exchanged in any twelve consecutive months, the partnership will be deemed terminated. Termination of the original partnership would be interpreted by the IRS as a sale and would result in a tax liability for the original investors. The "new" partnership would not be considered to be a "first user" of the depreciable property acquired from the prior partnership and could not compute depreciation under the accelerated method. This result substantially reduces all major tax shelters for the second partnership.\footnote{11}

If, however, the new investors do not purchase their interests from the original investors, but contribute capital to the partnership's continuing operations, such contributions are not treated as a "sale or exchange" and the partnership is not considered terminated.\footnote{12} Therefore, the now-enlarged partnership continues to obtain tax benefits on the basis of the accelerated form of depreciation. Thus, it is critical to preserve the original partnership so that full tax benefits can be obtained and additional capital from new investors can be attracted.
Limited Partners' Participation in Workouts

From our previous discussion we have seen that mortgage defaults may be caused by the following:

- inadequate management,
- marketing problems,
- inflation-related problems,
- particular types of projects in particular locations (e.g., central city rehab project involving several non-contiguous buildings), and
- tenants' inability to pay rent, etc.

Whatever the reasons, it is unlikely that the limited partners understand the operational problems encountered by the project, because of the inactive role they play in development affairs. The inactive role of limited partners prevents them from obtaining adequate information to enable them to participate effectively in a workout plan.

Even though periodic financial reports and annual tax reports are provided to investors by the general partners, to the extent that the project has encountered financial difficulties, the information provided by the general partners is probably too out-dated to be of use to the limited-partner investors in a workout formulation.

Obtaining financial information and other data on a defaulted project, at the time of or just before default, is a major problem for investors. If the workout is negotiated directly by the builder-sponsor and the investor or underwriter, it is possible that the investors have ready access to project information. But in most cases, it is highly unlikely that investors can rely on associates who ini-
tially promoted the project to cooperate and affirmatively assist in the workout. The reason is that this assistance may expose associates to possible securities law violations that could be claimed against them by investors.\textsuperscript{14}

If a limited partnership is made up of geographically diversified investors and their investments are likewise geographically diversified, it is difficult for investors to participate in a workout. Even if the limited partner investors are organized and able to deal directly with creditors and the mortgagee in a workout situation, they can legally be liable as general partners as a consequence of such active participation. Limited partners are usually not allowed to make decisions concerning the business of the partnership. Because of their "limited" business authority, limited partners are only liable for the amount of cash invested and are not personally responsible for the debts of the partnership.

According to Article 7 of the Uniform Limited Partnership Act, "a limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business."\textsuperscript{15} In this event, liability exists for payment of partnership debts, except in the case of a non-recourse mortgage. These debts may be unpaid wages, supplies, utility expenses, etc.

Assuming that the limited partners are able to overcome the above-mentioned hurdle and are willing to take the initiative to negotiate a workout, sufficient time must be allowed for investors to
organize,
-agree on who will represent the investors,
-get the existing general partner or partners to agree
to accept the investors' representative in the workout,
-figure out how much cash is required to make the project viable,
-determine possible tax liabilities for each investor in case the mortgage is foreclosed,
-determine the period needed to continue project operation to recoup cash investments,
-find alternative management if management has been a problem,
-and find a new general partner or new general partners to join the partnership such that the original partnership is preserved.

Because of all the problems and risk involved in investor-initiated workouts, there must be adequate concessions to justify such action by them. Forbearance may provide a necessary incentive to investors.

Forbearance

A mechanism whereby additional funds can be used to support financially troubled developments is forbearance. Through forbearance, a portion of the mortgage payments is deferred. Some form of long-term forbearance can allow developments to continue beyond the point where default would otherwise occur. Forbearance of a portion of the mortgage payments allows for an indirect method of paying for increased costs, and may be tried if existing rent revenues are unable to meet expenditures. Foreclosure can then be avoided and the development con-
tinued on its 236 subsidy, to the benefit of the low and moderate in-
come tenants residing there.

There may be tax benefits generated from forbearance which can
themselves generate additional investments by investors — cash that
can be used to help the development. In the following section, the
tax aspects of forbearance and certain legal restrictions which may
prevent benefits from being realized are discussed.

The Internal Revenue Service has said that "excess" tax deductions
produced by an investment having no profit potential are not allo-
vable. Excess deductions are generally considered to be the amount
of annual tax deductions with respect to a property that exceeds the
sum of the annual income plus the amount of repayment of the mortgage
and required reserves. If the economic effect of a long-term for-
bearance program is to virtually eliminate the possibility of current
or future income or increased equity through mortgage amortization,
the IRS may disallow the excess deductions. Another problem is that,
according to the IRS, capital contributed by investors in order to
defer mortgage payments may be looked upon as a new investment; and
therefore the original partnership is considered terminated. Thus,
by this line of reasoning, the new investment has been made without
the intention of receiving a profit, but merely for the purpose of
creating a tax shelter for the investors' other income. In this case,
all future excess depreciation deductions are disallowed. This IRS
policy discourages additional capital contributions as a condition
for forbearance.
Possible Tax Benefits to Investors Through Forbearance

Forbearance for any period of time may produce additional tax shelter benefits for a project. Interest that is based on a forbearance, but is added to the principal and is due at maturity, may result in a tax shelter if taxable income or loss goes by the accrual method of accounting. Deduction for accrued but deferred interest is a possible incentive to investors, because it is similar to a non-cash deduction that can shelter other income.

Investors in an accrual-basis partnership take into account the possibility of increased deductions by virtue of the deferred interest. According to existing Treasury regulations, "deferral of the time of payment of an otherwise deductible item does not affect its current allowability as a deduction by an accrual basis taxpayer. But there may be a drawback, in that accrual deduction may not be allowed if there is no intent to pay the deferred interest in the future.

In general, the rule appears to be that deductions for interest may be accrued if, at the time the deductions were taken "it could not have been categorically stated that the interest would not be paid." Thus, so long as the workout agreement merely defers the obligation to make interest payments, but specifically does provide that all such deferred amounts will be payable on some fixed date, then accrued interest may be deducted.

Even if the investors cannot be certain of permission to deduct for such accrued interest, they would consider the possibility
of such a deduction as a major factor in a workout.

For the investors, the greatest benefit is generated when a forbearance policy is initiated as early as possible. For example, in a fifteen percent investment situation, a seventy percent tax bracket investor benefits $22,770 after two years, $21,115 after five years, and only $16,642 after eight years of project operation. Tax benefits are based on total benefits generated from the remainder of the twenty year term through long-term forbearance (see Figure 7).

It is interesting to compare the status of the investors in the case of a foreclosure, as shown in Figure 8, with the benefits they derive from staying with the project under a two-year or a lifetime forbearance. A seventy percent tax bracket investor with fifteen percent of the project mortgage would have, at foreclosure after two years of project operation, an unrecovered investment of $5,935. However, if the investor remains with the project (with a two year forbearance), he realizes a net benefit of $22,770, for an "in pocket" gain of $16,835. In the case of the lifetime forbearance policy, the investors obtain greater benefits. The same seventy percent taxpayer is enriched by $34,624. In almost every situation the investors profit by staying with the project, and their benefits are proportional to their tax brackets and the timing of the implementation of the forbearance policy.

The most important component of the future losses in a forbearance is the accrued interest on the unpaid portion of the mortgage. The accrued interest has the same tax effects as tax deduction without cash outlay.
In the case of a short-term forbearance of two years, with the project being held for twenty years, the denial of the deductibility of accrued interest is not critical to the final result (see Figure 7). However, it is a different matter for a project that receives a lifetime forbearance. In this situation, the deduction of accrued interest results in substantially greater net benefits to the investors.

Investors generally pay a higher price to purchase an interest in a rehab project than they do for one newly constructed. The price may range from eighteen to twenty-six percent of the mortgage. For any tax bracket, investors recover less of their investments after foreclosure of a rehab project than they do after foreclosure of a newly constructed project (see Figure 9). However, because depreciation deductions for rehab projects can be made over five years, whereas deductions for new construction must be made over thirty to thirty-five years, investors receive a greater return from rehab construction. For investors, the contrast between the results of foreclosure and forbearance is great. For example, an investor who has a ten percent interest in a development and is in a fifty percent tax bracket, and who still has $527.00 (unrecovered) in the project suffers a $16,533 loss with foreclosure, but gains $19,990 with a two year forbearance and $27,287 with a lifetime forbearance (see Figure 10).

We can see that most investors would want to avoid foreclosure, preferring the possible added tax benefits from a forbearance. If additional funds are raised, they can be used as incentive fees to
induce new management to oversee the project, which in turn would allow this contribution to be a tax deductible expense. In the following section, we will see how contributions from investors can be treated as deductions when used for various purposes in the project.

Deductions for Repairs

The treatment of investor contributions and any other funds used for repairs is an important consideration with respect to their tax deductibility. There is greater attraction to investors if their contributions to a project can be immediately deductible. Regarding the deductibility of capital contributed for repairs, required because of deferred maintenance or vandalism:

"...the cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense provided the cost of acquisition or production or the gain or loss basis of the taxpayer's plant and equipment is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall be capitalized and depreciated." 22

To distinguish between what is considered a capital expenditure and what is considered an expense item, we state the following:

"In determining whether an expenditure is a capital one, or is chargeable against operating income, it is necessary to bear in mind the purpose for which the expenditure was made. To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keep-operating condition. It does not add to the value of the property, nor
does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the users for which it was acquired. Expenditures for the purpose are distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the other are additions to capital investment current earnings.  

There are various factors which are important in determining the deductibility of repair costs for the buildings involved in workouts: 1) if repair expenditures are made solely for the sake of complying with building code regulations, they are not considered to be deductible, 2) expenditures made as part of a plan to put a building in ordinary operating condition (that is, to recondition, as opposed to keeping it in good condition) are generally treated as deductible repairs.

From these trends it seems that major repair expenditures which prolong the life of a building are not allowed to be deducted from operating income as an expense. This inability to deduct repair expenses is a disadvantage to investors, who want to obtain immediate tax deductions for their contributions.

Conclusion

The use by HUD and the MHFA of tax leverage in a workout is a major negotiation tool. To employ tax leverage, detailed information from the investors as to the terms upon which the project was acquired, statements as to the actual tax benefits derived to date, as well as other related data (financial records, etc.) are required. It may be
difficult to obtain such information and efforts to do so may result in considerable controversy concerning privacy of personal finances. HUD and the MHFA may only be able to make assumptions about the investors' tax positions in their negotiations.

One of the key incentives for additional capital contributions by investors is the added tax benefits realized through long-term forbearance. Granting forbearance can be used by HUD, but can be financially detrimental to the MHFA, which depends upon the repayment of interest and principal from its outstanding mortgages to pay the Agency's bond holders. Ultimately, understanding the tax position of limited partner investors is a vital tool in workout negotiations, negotiations which seek to obtain additional capital for a development sorely in need of financial aid.
MECHANISMS TO AVOID FORECLOSURE

In our previous discussion we analyzed the workout mechanism that may be used to avert foreclosure. In this Chapter we will discuss other possible mechanisms that could be used singly or in combination to help avoid foreclosure and to insure long-term project viability. In the first half of this Chapter we will discuss mechanisms that could be useful to both HUD and the MHFA. These mechanisms are mortgage writedown, additional subsidies, debt service deferment during rent-up, and savings on construction costs. In the second half of the Chapter we will discuss certain techniques presently used by the MHFA which may be adopted by HUD to improve their program. They are setting up reserves for developments, and mortgage refinancing for repairs and upgrading. We shall also discuss HUD's need to restructure its own agency organization and the methods by which it implements housing programs.

Financial Alternatives Available to HUD and the MHFA

Mortgage writedowns: for financially troubled developments that have not been foreclosed, the writedown of existing mortgages would allow continued operation of these properties as housing for low income families. A writedown is the reduction of a debt in order to bring it into agreement with its present "going" value. Because of
the potential project deterioration and hardships faced by tenants during and after the sale, a writedown could be necessary to avert these consequences.

A foreclosure sale usually would not generate enough funds to pay the total balance of the outstanding debt and a loss would be incurred. HUD or the MHFA would gain little on a sale as compared with a reduction of the mortgage. With either one, the loss is about the same. But through the writedown, the ramifications of foreclosure are avoided and future interest subsidy payments are reduced.

The writing down of existing mortgages by HUD may be politically undesirable because of the increase in cost to the federal government. This problem can be overcome if relief can be applied in the form of a forbearance. Debt would still be outstanding but debt service would not be paid. This form of relief has been discussed in chapter seven.

For the MHFA, this writedown strategy is possible only if reserves plus other funding sources are available to support this measure. Since the MHFA must be financially responsible to its bondholders, any loss due to the writedown of a mortgage must be made up by other funds. Presently a loan loss reserve of over four million dollars has been established, but this amount is not sufficient to aid a large number of units. Co-insurance with the federal government may provide the necessary resources to support writedowns. Without co-insurance the MHFA, is unable to use writedowns, or it jeopardizes its financing capacity.

The writedown, when used instead of foreclosure, could relieve both HUD and the MHFA of potential ownership and management responsi-
bilities. The writedown of the mortgage could be to a level which the project's income can support.

The tax consequences to the mortgagor of the writedown of a mortgage depend on many circumstances. When there is a cancellation, forgiveness, or reduction of mortgage indebtedness, as in a writedown, and where the property is not lost through foreclosure, or voluntary conveyance, or abandonment; Section 61(a)(12) of the Internal Revenue Code provides that the amount of debt which no longer need be paid constitutes ordinary (taxable) income to the debtor.

But there are exceptions to the general statutory rule that provide significant tax relief in appropriate circumstances: there is no taxable income created where the mortgagor is not personally liable for the debt. In this case, the debt reduction is treated as reduction in the basis. Since mortgages under HUD and the MHFA are non-recourse instruments, the mortgagors are not liable for mortgage debts and writedowns do not result in taxable income to the mortgagors.

Additional subsidies: currently Section 236 subsidies only reduce debt service charges. From the very start, the 236 program failed to incorporate provisions for operating subsidies which, it is clear, in periods of inflation become a vital component of project planning. Initially it was hoped that a debt service subsidy would enable the government to make housing affordable to low and moderate income families. The Section 236 subsidy is fixed and has no provisions for increased operating costs, or other economic factors which have made decent multi-family housing out of the economic reach of these families.
If Section 236 developments are allowed to switch to new Section 8 housing allowance subsidies, these developments will be affordable to low and moderate income families. Section 8 outlines a straightforward subsidy program that will serve both low and moderate income families. The difference between what a tenant can afford to pay (fifteen to twenty-five percent of his income) and the fair market rent for the unit will be paid by HUD. But presently Section 8 funds are encumbered by restrictions against their use as a means of refinancing subsidized housing projects or as a means of providing operating subsidies. HUD could lift these restrictions or develop a subsidy program to cover project operating costs. Annual subsidies can be implemented and would be desirable from both policy and budgetary points of view, because they can be modified every year in response to the needs of developments. This provision of subsidies would be beneficial to both the MHFA and HUD.

Debt service deferment during rent-up: one mechanism available to HUD which is currently being reviewed by the MHFA is a six month grace period, during which debt service does not have to be paid to allow for rent-up. Also, HUD would benefit from this mechanism if it were applicable to multi-family projects that have troublesome rent-up periods and/or during periods when developments are unable to generate enough revenues. Revenues received during this period would be used to pay expenses. The unpaid debt service would be capitalized in the mortgage.

Cost savings in construction: currently under both the MHFA and HUD programs, a builder's profit is calculated on the basis of total
building costs. The more costly the building is, the more profit the builder gets. The practice of sharing construction savings with owners has been common in the conventional construction industry. Permitting contractors to share in any savings they might realize would encourage them to reduce construction costs as much as possible. Savings could be realized without sacrificing the quality of the development. Construction cost savings would help lower building costs for both HUD and the MHFA.

Program Improvements Available to HUD

Now we will discuss mechanisms presently used by the MHFA that can be adopted by HUD to improve that Agency's response and effectiveness.

Reserves: for HUD developments, funded replacement reserves could be set up (as exist now in the MHFA) in order to fund repairs. This would prevent deterioration of developments and cover the cost of unexpected maintenance.

Escrow of builder/sponsor profit risk allowance: HUD could escrow the BSPRA, as the MHFA does with the developer's fee (the two are different terms for the same thing). The BSPRA could be paid out over a three year period to insure successful operation of developments. Whatever deficits occur during this period could be paid by the BSPRA. The BSPRA could vary according to the size and risk of the project (it is now a flat ten percent for developments, and has no direct relationship to the amount of effort required from the developer), and be
based on a sliding scale with respect to project size and the risk involved.

Funds for repairs and upgrading: currently many financially troubled developments are in a chronic state of disrepair. Before any viable financial/management scheme can be effectively implemented, the needed repairs must be made. Certain capital expenditures must be made to produce reductions in maintenance and repair expenditures.

Where possible, there could be mixed income housing (HUD does not now have this under its 236 program). Through economic integration, better economic stability is achieved in the developments because of the greater elasticity of the tenants as a group to absorb increased costs. Inclusion of higher income tenants would help support mortgage increases for the funding of necessary repairs and upgrading of the development.

HUD could provide amenities which would upgrade developments and enable them to compete on the conventional market. These improvements would help maintain project stability with low income tenants, who often move out of housing developments when their incomes increase and they find that their housing dollar is better spent for conventional market units. Upgrading would make developments more desirable places to live and keep these tenants from moving out.

Mixed income developments: a possible roadblock to be faced by a developer in conversion to a mixed income development is reluc-
tance of low income tenants to move out to make way for middle and upper income tenants. This situation may be remedied through natural attrition in the development, but this can be a slow process.

Some complications for HUD of conversion to mixed income housing may arise out of a development's present location, which may prevent attraction of middle-upper income families no matter what amenities are provided. Additionally, the development's reputation may be a marketing handicap. Furthermore, the physical design configurations may prevent amenities from being added. New project construction on an adjacent site may allow for upgrading by extension of amenities from the new project to the already-existing housing development. Combined housing developments enable a larger area to be turned into a micro-environment, and possibly can neutralize the impact of adverse surroundings.

The mixed income approach has been the basic policy of the MHFA and has been implemented successfully throughout their developments. HUD can benefit from this approach; having mixed income housing could help insure the stability of project finances.

HUD and an increase in responsiveness: one of the reasons for the MHFA's lack of housing defaults is the intensity of monitoring and servicing that Agency provides to its developments. HUD area offices have played an almost passive role, on the other hand, due to inflexibility and/or inability to make decisions. Many decisions must be channeled to regional or even to Washington offices before action may be taken. This does not encourage fast or direct dealing with problems.
HUD could give more direct responsibilities to area offices. They could be allowed to determine the types of projects that should go in a particular area. HUD could become like the MHFA with respect to responsibility and flexibility.

Also, processing housing proposals has been cumbersome because they must be accepted by both the regional and the Washington HUD offices. One-stop processing could be provided if approval responsibility were more localized. Local responsibility would shorten processing time, which would enable the project to be built before inflation renders the development unfeasible.

Rent increases: with additional responsibilities given to HUD area offices, rent increases could be granted more quickly. Applications for increases could then be processed within a thirty day period. Increases could be based on projected expenses and not on past expenses, in order to have enough funds for adequate housing services. Currently rent increases are based on past expenses, with the result that revenues do not meet expenses.

Design flexibility: detailed governmental design reviews have not allowed for flexibility in design of HUD projects. The MHFA has been flexible with architects and has held them responsible for specific design decisions. The MHFA has concerned itself with the major criterion of producing housing of a design quality that is equal to or better than conventional apartments. If HUD is going to produce well-designed and architecturally sound projects, it must be willing to work with architects in a fashion that more closely approximates that
which is typical for conventionally financed projects.

**HUD and provision of financing:** by raising money through the bond market, the MHFA has been able to lend at lower rates than conventional lending institutions. Under HUD's program, money is obtained through conventional lending institutions at higher interest rates. The subsidy support required to lower mortgage interest rates to one percent under conventional financing is greater than that required under MHFA financing. HUD could realize savings on interest charges if it could provide its own funds for projects through federal financing. (The mortgage rates received would be equal to or less than MHFA rates.) The lower rates obtained by federal financing would be due to the high quality of security on these notes. The drawback, of course, is that the mortgage financing would be included in the federal budget and this could lead to reluctance on the part of Congress to back HUD projects. Such reluctance could be overcome if Congress would give the power to borrow funds to the Federal National Mortgage Association (FNMA), the Government National Mortgage Association (GNMA), or to a new financing entity - power backed by the full faith and credit of the federal government. If HUD could raise funds through the FNMA/GNMA, then project mortgages would not add to the federal budget.

**Conclusion**

A combination of financial mechanisms to avoid foreclosure and better control over certain expenses can be used to reinforce the financial foundation of developments. These mechanisms and controls,
used alone, cannot insure financial viability. Active participation, flexibility in program structure, and direct responsibility on the part of HUD and the MHFA for the development/management process are all vital to the success of subsidized housing developments.
Chapter Nine

CHANGE OF OWNERSHIP IN HUD DEVELOPMENTS

Change of ownership can be seen as a drastic, and yet unique, means of "boiling out" a project; that is, of keeping the project within the reach of low income families. Ownership forms that will be discussed are non-profit conversion to limited dividend status, HUD sales to local housing authorities, and encouragement of the IRS "rollover" provision for tenant ownership. A model of tenant ownership, currently being proposed jointly by Greater Boston Community Development, Inc. and Community Training Dynamics, Inc., will be examined in depth.

Non-Profit Conversion to Limited Dividend Status

A non-profit development that has been foreclosed or is in default can be sold and converted to a limited dividend development, and the resulting cash can be invested for the benefit of the development.

Conversion to a limited dividend development produces attractive tax benefits through depreciation. The depreciable base of the development is the amount of the unpaid mortgage, plus any cash invested from the limited partner investors. Since conversion probably results in a second-user status, only 125 percent of straight-line depreciation may be taken. Still, the tax benefit generated is at-
tractive if there is a guarantee that there will be no foreclosure on
the mortgage for a predetermined period, such that all investors
recoup at least the amount of their original investments. Also, for-
bearance of some portion of the mortgage debt service, which results
in the accrual of deferred interest, might provide an additional tax
attraction to investors.¹

The possible tax benefits to an investor of a non-profit 236 pro-
ject which is reconstituted as a limited dividend 236 project is shown
in Figure 11. This Figure shows benefits that are available to an
investor owning one-hundred percent of the project. The combination
of lifelong forbearance and depreciation results in an attractive
benefit to investors.

**HUD Sale to Local Housing Authorities**

The sale of HUD projects to local housing authorities would at
least leave housing developments available to low income tenants. HUD
236 developments are packaged housing resources that can be owned and
managed by local housing authorities immediately. Of course, for this
to happen, HUD must be willing to allocate to local authorities the
necessary public housing subsidies and funds for improvement before
the transfers can be made. Sale to local housing authorities would
relieve HUD of management/ownership responsibility and leave fore-
closed housing resources available to low income families. Families
who have incomes above public housing levels but cannot afford market
rents are not benefited by such sales.
Encouragement of Rollover Provision

The rollover provision under the IRS tax code allows sale to tenants without the consequence of depreciation recapture, as long as proceeds from the sale are reinvested in another subsidized project. The rollover provision has not been widely used because financial benefits allowed to investors are not attractive enough to facilitate these transfer sales. Another drawback to such sales is the unavailability of qualified tenant organizations to sell to.

Currently, since many HUD developments face foreclosure, investors may be willing to consider the use of the rollover provision; but education of tenants towards ownership must be carried out by owners if responsible management/ownership is to be obtained. Funds could be provided for planning and tenant takeover of ownership. Tenants could be taught that as owners they would have the benefit of tax deductions for interest and for tax payments, in addition to the possibility of building up equity in the project.

To date, the IRS rollover provision has been used only as an escape, to permit sale of financially troubled developments to tenants. Incentives could be provided for sponsors to transfer control of financially healthy developments to project occupants. If developments are in good repair and are financially sound, and sponsors can prepare tenants for ownership transfer, then HUD could give sponsors a fee for their efforts towards this transfer.
Tenant Ownership Model

For developments that have been foreclosed or are in the process of being foreclosed, conversion to cooperative or tenant owned developments may bring more responsible management to them. Two non-profit corporations have submitted a joint proposal to develop a pilot program in a Roxbury project which is designed to relieve HUD-Boston of management and ownership responsibilities for foreclosed properties, and to secure tenant owned housing on a long-term basis.

Greater Boston Community Development, Inc. (GBCD), a non-profit housing development and management consulting firm, and Community Training Dynamics, Inc. (CTD), a non-profit minority development and construction training organization, are negotiating a purchase option with HUD that would permit CTD and project residents to acquire ownership at the end of a two year period. GBCD would give technical assistance during the transfer.

According to the GBCD/CTD model, its purpose would be to increase residents' involvement and control over project operations. The proposal asks that HUD ultimately transfer multi-family properties to tenant cooperatives or community groups.

Supporters of this model hope that greater resident involvement in the management and ownership of subsidized housing will help resolve such major physical, social, and financial problems as vandalism, lack of reasonable security for tenants, and polarization of management and tenants.
This model would deal not only with the day to day operation of the buildings, but also with a wide range of tenant needs and social services. (This proposal provides for voluntary interaction between various social agencies and residents who want to take advantage of their services.)

The transfer of distressed properties to tenant cooperatives or community groups would shift the control and responsibility for these housing projects to the people they were meant to benefit. In financially troubled developments, increased maintenance and utility costs could be lowered by greater tenant involvement. Savings could be accomplished by tenants taking personal responsibility for maintenance repairs and conserving energy to keep utility costs down. If tenants receive information, they could learn how rents are related to operating costs and how their efforts could lower these costs. With buildings under tenant ownership, hopefully tenants would be willing to expend energy to make developments work, since it would be in their interest to do so.

The proposal provides for testing of the economic, physical, and social feasibility of transfer of ownership; and requires that the transfer of property be accomplished only when proper knowledge and skills for responsible property ownership have been acquired. Benefits of ownership would be explained to existing tenants by CTD/GBCD, and tenant participation in the CTD/GBCD program would be solicited. One benefit that could be emphasized would be that under tenant ownership, rent levels could be kept affordable partly due to a relatively low sale price from HUD.4
Tenant ownership would also benefit the wider community (in this case, Roxbury); the process of project default, foreclosure, deterioration, eviction and abandonment by residents, and ultimate demolition of buildings only blights the neighborhood and eliminates housing resources for low income families. Tenant ownership would not only break into this chain of events, it would better insure continuing project operation and conservation of housing resources.

The CTD/GBCD would provide two years of interim management services for these buildings before the transfer. This would be a time for tenants to learn about and get involved in management responsibilities and the advantages of ownership. The CTD/GBCD would structure a management system that would be useful whether or not the residents assumed ownership at the end of the two years, and that would show residents how to improve their living environment.

There has been a problem of attitude toward ownership on the part of residents, because they perceive that their existing neighborhood and living environment is unsafe and is an undesirable place to be. CTD/GBCD is formulating an approach to encourage low and moderate income residents to remain in subsidized developments, by helping them to create a more satisfying housing environment and to cope with rising housing costs.

During the two year period HUD would provide financial assistance toward transfer of ownership. The management fee would be set at eight percent of gross rents, instead of the usual five percent. Subsidized housing management fees have not been sufficient, especially
in central city areas where tenant needs are greater. The increased fee would allow for adequate management.

CTD/GBCD would, according to the model, acquire properties from HUD that presently have little or no potential for sale on the open market. CTD/GBCD is currently negotiating an acquisition price that could be supported by conventional financing. HUD's existing acquisition price formula has not reflected the higher interest rate required by conventional financing institutions. This has resulted in sale prices that cannot be supported by conventional means. CTD/GBCD has proposed a new formula that would better reflect the current higher interest rates. A more realistic sale price would result in rent levels affordable to residents.

CTD/GBCD has also proposed that HUD provide the necessary funds for repairs in this Roxbury development, averaging $1,800 per apartment. The price of the buildings would be set at one half of the cost of repairs, plus the cost of operational deficits, minus net income returned to HUD, for the two year interim management period.

This price setting method would motivate potential owners to minimize repair costs and to keep operating deficits at a minimum. The amortization payment on the sale would be generated from increased income from decreased arrearages, vacancies, and increased tenant participation in maintenance and management. Making repair funds ($1,800 per apartment) available in the beginning would eliminate maintenance deficiencies that have plagued the buildings. The provision of funds for needed repairs is the essential part of the overall
strategy for dealing with the problems of these buildings.

The necessary funds for the planning and implementation of this program would come from the Ford Foundation. The transfer of properties in a small area, such as this in Roxbury, would allow for better control by tenants, and make for a more livable project. The key to success is the change in tenant attitude regarding their environment, for which they would have responsibility as owners. It is hoped that this pilot program will be successful, thereby creating new policies to deal with subsidized housing.

The drawback of cooperatively owned developments is the inability to guard against irresponsible members of the cooperative. A development under a cooperative arrangement could rapidly deteriorate with high vacancy rates or with delinquency of rent payments on the part of even a small number of tenants.

But on the other hand, cooperative housing offers a relatively simple way for families to own their own homes. Home ownership not only engenders a sense of pride and stability, but a home also is the one long-term investment a family is most likely to make. The CTD/GBCD tenant ownership proposal would give low and moderate income families the opportunity to own a home.
CONCLUDING REMARKS: NEW ALTERNATIVES

The present system under the Section 236 program does not foster responsible long-term ownership/management. Given the major role that HUD and the MHFA play in the area of subsidized multi-family housing, there should be program restructuring to insure that the needs of low and moderate income families are met. There could be a change in the ownership format of multi-family projects; and new financial incentives and subsidies are needed to obtain responsible long-term operation and management of subsidized units.

The current tax structure provides limited dividend sponsors with financial incentives to develop projects, but the resulting tax shelter benefits are usually depleted after fifteen to twenty years. The cash flow becomes a negative incentive to continue owning a subsidized multi-family project, once the tax benefits have been exhausted. While non-profit sponsors are not affected in any way by the tax shelter system, they do not generally have sufficient skills and financial resources to absorb the cost of ongoing project management.

The HOMES Proposal

In an effort to find a way to insure responsible long-term ownership/management of subsidized housing for the future, a study done by the National Center For Housing Management, Inc. examines an entirely new ownership system for subsidized multi-family housing projects. Under this proposal, sponsors would be given financial incentives to
both initiate and responsibly manage subsidized multi-family projects over the whole forty year term of a mortgage.

Under this system, which would be based on regulatory controls and cash incentive, the Housing Ownership Management Entities (HOMES) would not realize automatic and arbitrary financial gains or losses by virtue of the tax system. Instead, the amount of income that each HOME earned would be dependent on how well it actually performed its ownership/management role over a full forty year term. HOME ownership could be implemented for developments under HUD or the MHFA (or other State housing finance agencies) - new developments, those a few years old, or even those that have been foreclosed.

Restructuring Financial Incentives

Under the proposal for ownership, there would be a restructuring of financial incentives. To reduce risk during the construction period, sponsors could be responsible for their own interim construction financing. Sponsors under HOMES would be forced to depend on their reputations and internal strengths in order to receive loans from particular mortgagees. Since there would be no guarantees or construction financing from government housing agencies, the interim lender would take a more active role in monitoring the sponsors to make sure the project could be built for the estimated costs. HUD and the MHFA would provide the permanent take-out mortgage once the project were completed and met specifications.
The disadvantage of this conventional construction financing is that developments would not have the lower interim financing interest that is available from the MHFA or federal financing. The savings in interest cost could be plowed back into the development to improve its quality.

One hundred percent financing of the permanent mortgage could be supplied. In the past, limited dividend sponsors have pledged their developers' fees (BSPRA) as equity and profit has been obtained by the syndication of their interest. The equity requirement is in reality only "paper equity".

Currently, the time when developments are to be refinanced is after twenty years of operation. Because of this long lock-in period, future proceeds from refinancing are not very attractive to investors. Refinancing occurs so far in the future that sponsors are not encouraged to add funds to developments. The lock-in period for refinancing could be shortened to ten to fifteen years, to allow a greater possibility of obtaining refinancing proceeds. The shorter lock-in period would encourage investors to allocate cash for improvements in developments, to retain their market value.

Bonus System

To insure good management, there must be sufficient rewards. Management bonuses have been suggested by MHFA staff as a means of insuring long-term responsible management. A bonus plan suggested by the National Center For Housing calls for ownership reserves of ten
percent of the total project replacement cost, to be held by the federal government and reinvested to generate interest. After the third year of operation, the return on the reserves could be utilized to pay an additional ownership/management bonus. If management has difficulty operating the project, it would be required to use the bonus to meet project expenses. The amount of bonus would increase over time.

The MHFA and HUD could reinvest funded replacement reserves and the interest generated could be used as a potential management bonus. A ten percent reserve of total replacement cost would raise rents five to seven dollars per apartment, based on a three percent constant on the mortgage. The bonus that management could generate on each apartment would be about $150.00 per unit.

For especially troublesome developments in central cities, HUD and the MHFA could increase ownership reserves to fifteen percent of the total replacement cost; thus additional bonuses could be generated to attract responsible management/ownership.
FIGURES
Figure 1.
Replacement Cost, Mortgage and Stated Equity

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land Improvements</td>
<td>$22,500</td>
</tr>
<tr>
<td>Construction of building</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Total structures</td>
<td>1,022,500</td>
</tr>
<tr>
<td>Architects' fees—design and supervision</td>
<td>56,423</td>
</tr>
<tr>
<td>Bond premium</td>
<td>5,293 (TD)</td>
</tr>
<tr>
<td>Interest during construction period @ 8½%</td>
<td>57,375 (TD)</td>
</tr>
<tr>
<td>Taxes</td>
<td>8,000 (TD)</td>
</tr>
<tr>
<td>Insurance</td>
<td>4,000</td>
</tr>
<tr>
<td>FHA mortgage insurance premium (½%)</td>
<td>6,750 (TD)</td>
</tr>
<tr>
<td>FHA examination fee (½%)</td>
<td>4,050</td>
</tr>
<tr>
<td>FHA inspection fee (½%)</td>
<td>6,750</td>
</tr>
<tr>
<td>Financing fee (2%)</td>
<td>27,000 (TD)</td>
</tr>
<tr>
<td>FNMA fee (1 3/4%)</td>
<td>23,625 (TD)</td>
</tr>
<tr>
<td>Title and recording</td>
<td>6,000</td>
</tr>
<tr>
<td>Legal and organization</td>
<td>8,800</td>
</tr>
<tr>
<td>Other costs</td>
<td>15,404</td>
</tr>
<tr>
<td>1. Total certifiable cost</td>
<td>$1,251,970</td>
</tr>
<tr>
<td>2. Other cost elements—not cost certifiable:</td>
<td></td>
</tr>
<tr>
<td>Builder's general overhead (2% of structure costs)</td>
<td>$20,757 (TD)</td>
</tr>
<tr>
<td>3. Land-market value per FHA</td>
<td>100,000</td>
</tr>
<tr>
<td>4. Total cost excluding BSPRA</td>
<td>$1,372,727</td>
</tr>
<tr>
<td>5. Allowance by FHA for Builder and Sponsor Profit &amp; Risk (BSPRA) (10% of the sume of certifiable costs plus builder's general overhead allowance)</td>
<td>127,273</td>
</tr>
<tr>
<td>6. Total Estimated Replacement Cost</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>7. Mortgage-90% of Item 6</td>
<td>$1,350,000</td>
</tr>
<tr>
<td>8. &quot;Stated Equity&quot;-10% of Replacement Cost</td>
<td>$150,000</td>
</tr>
</tbody>
</table>

(TD) = Tax deductible items during construction period ($143,507)

**Figure 2.**

Profit if Builder-Sponsor Sells Property

<table>
<thead>
<tr>
<th>Sales Price (replacement cost)</th>
<th>$1,500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costs:</td>
<td></td>
</tr>
<tr>
<td>Mortgage-Figure 1</td>
<td>$1,350,000</td>
</tr>
<tr>
<td>Actual investment</td>
<td>63,227</td>
</tr>
<tr>
<td>Total cost</td>
<td>1,413,227</td>
</tr>
<tr>
<td>Profit to builder-sponsor</td>
<td>$86,773</td>
</tr>
<tr>
<td>After taxes-assume 50% bracket</td>
<td>$43,387</td>
</tr>
</tbody>
</table>

space set aside for community functions; toilet facili-
ties should be provided as part of this area. Storage fa-
cilities and ventilated laundry facilities should also
be included.
recreation facilities should be included as a part of
its overall design. Some examples are: tennis courts,
basketball courts, swimming pools, shop with lockers for
tools, photography darkroom, exercise room, sauna, etc.
These facilities should be carefully thought out and
related to the size of the project and the type of
tenants.
Three and four bedroom apartments should not begin over
1 1/2 stories from the ground.
Buildings taller than 3 1/2 stories should have elevators.
All apartments should provide a refrigerator, range and
disposal.
Three bedroom apartments should have at least 1 1/2
baths and four bedrooms and larger 2 baths.
Three bedroom apartments and larger should have a den
or a dining room separate from the kitchen.
Any project with more than 100 bedrooms should provide
a program and facilities for children's day care.
Any existing exposed brick, interior or exterior, will
be steam-cleaned or sand-blasted and completely repointed.
No plywood or concrete block products should be used as
an exterior wall material, except as fencing.
All bathrooms should have ceramic tile on the floor and
ceramic tile around tub. Fiberglass tubs, vinyl asbestos
tile or carpet flooring are not acceptable in bathrooms.
Shelves and by-folding doors shall not be made of metal.

Source: Operations Handbook For Financing Of Multi-Dwelling
Housing, Massachusetts Housing Finance Agency,
Figure 4.

Tenant Selection Criteria

The following priorities will be the basis for resident selection for all applicants at all income levels. The priorities are listed in order of preference and are subject to whatever Federal or State priorities are or may be imposed.

I. Displacement with a two-year period.
   A. Due to natural disaster, fire, public action or urban renewal.
   B. Due to private eviction beyond the control of the resident.

II. Poor housing conditions.
   A. Substantial substandardness.
   B. Overcrowded conditions.

III. Rent in excess of 50% of applicant's adjusted annual income.

IV. Special personal situations
   A. Handicapped.
   B. In military service where head of household is stationed away from home

V. Applicants who receive public assistance will take priority over any of the above priority categories if the selection based on the categories 1 through 4 results in the following:
   non-compliance with MHFA regulations that at least 25% of the low income units shall be for welfare recipients.

### Figure 5.1

#### OPERATING COST ANALYSES

<table>
<thead>
<tr>
<th>Project</th>
<th>SIZE</th>
<th>AVG.#</th>
<th>POWER</th>
<th>PAYROLL</th>
<th>OPER + MNT.</th>
<th>OPER/MNT</th>
<th>ADMIN.</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>BR.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A.</td>
<td>214</td>
<td>1.14</td>
<td>434</td>
<td>81</td>
<td>176</td>
<td>256</td>
<td>137</td>
<td>827</td>
</tr>
<tr>
<td>B.</td>
<td>156</td>
<td>1.33</td>
<td>449</td>
<td>115</td>
<td>239</td>
<td>354</td>
<td>139</td>
<td>943</td>
</tr>
<tr>
<td>C.</td>
<td>190</td>
<td>1.46</td>
<td>483</td>
<td>171</td>
<td>275</td>
<td>446</td>
<td>156</td>
<td>1085</td>
</tr>
<tr>
<td>D.</td>
<td>149</td>
<td>1.47</td>
<td>418</td>
<td>176</td>
<td>270</td>
<td>446</td>
<td>255</td>
<td>1119</td>
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<tr>
<td>E.</td>
<td>449</td>
<td>1.56</td>
<td>638</td>
<td>175</td>
<td>124</td>
<td>300</td>
<td>181</td>
<td>1119</td>
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<tr>
<td>F.</td>
<td>110</td>
<td>1.64</td>
<td>465</td>
<td>141</td>
<td>235</td>
<td>376</td>
<td>105</td>
<td>946</td>
</tr>
<tr>
<td>G.</td>
<td>288</td>
<td>1.69</td>
<td>451</td>
<td>104</td>
<td>216</td>
<td>320</td>
<td>151</td>
<td>924</td>
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<tr>
<td>H.</td>
<td>404</td>
<td>1.74</td>
<td>669</td>
<td>184</td>
<td>181</td>
<td>365</td>
<td>188</td>
<td>1222</td>
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<tr>
<td>I.</td>
<td>71</td>
<td>1.86</td>
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<td>222</td>
<td>224</td>
<td>446</td>
<td>201</td>
<td>1097</td>
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<td>J.</td>
<td>160</td>
<td>1.89</td>
<td>288</td>
<td>135</td>
<td>212</td>
<td>347</td>
<td>178</td>
<td>813</td>
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<tr>
<td>K.</td>
<td>204</td>
<td>1.90</td>
<td>464</td>
<td>188</td>
<td>298</td>
<td>487</td>
<td>207</td>
<td>1157</td>
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<tr>
<td>L.</td>
<td>312</td>
<td>1.92</td>
<td>548</td>
<td>257</td>
<td>152</td>
<td>409</td>
<td>156</td>
<td>1112</td>
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<tr>
<td>M.</td>
<td>100</td>
<td>1.96</td>
<td>350</td>
<td>190</td>
<td>217</td>
<td>407</td>
<td>175</td>
<td>932</td>
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<tr>
<td>N.</td>
<td>250</td>
<td>2.00</td>
<td>440</td>
<td>75</td>
<td>275</td>
<td>350</td>
<td>112</td>
<td>902</td>
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<tr>
<td>O.</td>
<td>288</td>
<td>2.13</td>
<td>506</td>
<td>182</td>
<td>144</td>
<td>326</td>
<td>136</td>
<td>968</td>
</tr>
<tr>
<td>P.</td>
<td>134</td>
<td>2.27</td>
<td>358</td>
<td>127</td>
<td>171</td>
<td>298</td>
<td>122</td>
<td>779</td>
</tr>
<tr>
<td>Q.</td>
<td>33</td>
<td>2.55</td>
<td>485</td>
<td>221</td>
<td>273</td>
<td>494</td>
<td>191</td>
<td>1170</td>
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<tr>
<td>R.</td>
<td>147</td>
<td>2.58</td>
<td>611</td>
<td>137</td>
<td>436</td>
<td>573</td>
<td>145</td>
<td>1329</td>
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<tr>
<td>S.</td>
<td>32</td>
<td>2.84</td>
<td>543</td>
<td>254</td>
<td>348</td>
<td>602</td>
<td>200</td>
<td>1345</td>
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<tr>
<td>T.</td>
<td>9</td>
<td>3.33</td>
<td>667</td>
<td>---</td>
<td>481</td>
<td>481</td>
<td>33</td>
<td>1181</td>
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### Figure 5.2

**PER UNIT IMPACT OF RECENT COST INCREASES**

<table>
<thead>
<tr>
<th>Project</th>
<th>Power Increase</th>
<th>Payroll Increase</th>
<th>Power Increase AS % OF Total Increase</th>
<th>Payroll Increase AS % OF Total Increase</th>
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<tbody>
<tr>
<td>A.</td>
<td>238</td>
<td>18</td>
<td>129.4%</td>
<td>9.8%</td>
</tr>
<tr>
<td>B.</td>
<td>224</td>
<td>14</td>
<td>128.2%</td>
<td>15.0%</td>
</tr>
<tr>
<td>C.</td>
<td>168</td>
<td>73</td>
<td>28.6%</td>
<td>20.6%</td>
</tr>
<tr>
<td>D.</td>
<td>128</td>
<td>17</td>
<td>3.8%</td>
<td>12%</td>
</tr>
<tr>
<td>E.</td>
<td>360</td>
<td>79</td>
<td>41.6%</td>
<td>61%</td>
</tr>
<tr>
<td>F.</td>
<td>193</td>
<td>52</td>
<td>64.1%</td>
<td>17%</td>
</tr>
<tr>
<td>G.</td>
<td>139</td>
<td>10</td>
<td>91.7%</td>
<td>6.4%</td>
</tr>
<tr>
<td>H.</td>
<td>469</td>
<td>68</td>
<td>94.9%</td>
<td>13.7%</td>
</tr>
<tr>
<td>I.</td>
<td>203</td>
<td>123</td>
<td>53.9%</td>
<td>32.8%</td>
</tr>
<tr>
<td>J.</td>
<td>40</td>
<td>34</td>
<td>132.7%</td>
<td>115.1%</td>
</tr>
<tr>
<td>K.</td>
<td>259</td>
<td>119</td>
<td>92.2%</td>
<td>42.4%</td>
</tr>
<tr>
<td>L.</td>
<td>273</td>
<td>182</td>
<td>68.1%</td>
<td>45.5%</td>
</tr>
<tr>
<td>M.</td>
<td>140</td>
<td>95</td>
<td>57.6%</td>
<td>39.1%</td>
</tr>
<tr>
<td>N.</td>
<td>226</td>
<td>5</td>
<td>68.4%</td>
<td>1.6%</td>
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<td>O.</td>
<td>177</td>
<td>115</td>
<td>64.1%</td>
<td>41.6%</td>
</tr>
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<td>P.</td>
<td>27</td>
<td>67</td>
<td>17.6%</td>
<td>44.5%</td>
</tr>
<tr>
<td>Q.</td>
<td>246</td>
<td>157</td>
<td>15.6%</td>
<td>32.8%</td>
</tr>
<tr>
<td>R.</td>
<td>276</td>
<td>58</td>
<td>57.1%</td>
<td>12%</td>
</tr>
<tr>
<td>S.</td>
<td>199</td>
<td>76</td>
<td>78.8%</td>
<td>30%</td>
</tr>
<tr>
<td>T.</td>
<td>404</td>
<td>50</td>
<td>110.9%</td>
<td>13.7%</td>
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</tbody>
</table>

### Recent Project Cost Increases

<table>
<thead>
<tr>
<th>PROJECT</th>
<th>TOTAL INCREASE</th>
<th>POWER INCREASE</th>
<th>PAYROLL INCREASE</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>AMOUNT - %</td>
<td>AMOUNT - %</td>
<td>AMOUNT - %</td>
</tr>
<tr>
<td>A.</td>
<td>39,400 - 7.9%</td>
<td>50,994 - 121.7%</td>
<td>3879 - 18%</td>
</tr>
<tr>
<td>B.</td>
<td>27,284 - 6.5%</td>
<td>35,000 - 100%</td>
<td>4100 - 18.6%</td>
</tr>
<tr>
<td>C.</td>
<td>67,867 - 11.7%</td>
<td>31,906 - 54.2%</td>
<td>14,006 - 76.1%</td>
</tr>
<tr>
<td>D.</td>
<td>66,688 - 12.2%</td>
<td>19,100 - 30.7%</td>
<td>2540 - 10.7%</td>
</tr>
<tr>
<td>E.</td>
<td>85,386 - 6.5%</td>
<td>161,611 - 129.2%</td>
<td>35,540 - 84.2%</td>
</tr>
<tr>
<td>F.</td>
<td>33,169 - 12.9%</td>
<td>21,273 - 71.3%</td>
<td>5732 - 58.5%</td>
</tr>
<tr>
<td>G.</td>
<td>43,618 - 5.8%</td>
<td>40,000 - 44.4%</td>
<td>2800 - 10.3%</td>
</tr>
<tr>
<td>H.</td>
<td>199,643 - 19.1%</td>
<td>189,464 - 234.5</td>
<td>27,440 - 58.4</td>
</tr>
<tr>
<td>I.</td>
<td>26,683 - 14.1%</td>
<td>14,381 - 81.6</td>
<td>8,750 - 125%</td>
</tr>
<tr>
<td>J.</td>
<td>4,726 - 3.8%</td>
<td>6,270 - 15.8</td>
<td>5440 - 33.8</td>
</tr>
<tr>
<td>K.</td>
<td>57,335 - 11.4%</td>
<td>52,850 - 126.4</td>
<td>24,330 - 173.3</td>
</tr>
<tr>
<td>L.</td>
<td>124,814 - 21.9%</td>
<td>85,060 - 99%</td>
<td>56,815 - 243%</td>
</tr>
<tr>
<td>M.</td>
<td>24,285 - 9.9%</td>
<td>14,000 - 66.7</td>
<td>9500 - 100%</td>
</tr>
<tr>
<td>N.</td>
<td>82,659 - 12.5%</td>
<td>56,550 - 105.8</td>
<td>1300 - 65%</td>
</tr>
<tr>
<td>O.</td>
<td>79,431 - 16.3%</td>
<td>50,896 - 53.6</td>
<td>33,050 - 170%</td>
</tr>
<tr>
<td>P.</td>
<td>20,224 - 6.2%</td>
<td>3,571 - 6.9</td>
<td>9000 - 112.5</td>
</tr>
<tr>
<td>Q.</td>
<td>15,761 - 24.5%</td>
<td>8,125 - 103.3</td>
<td>5175 - 245.8</td>
</tr>
<tr>
<td>R.</td>
<td>71,088 - 17.3%</td>
<td>40,615 - 82.6</td>
<td>8564 - 74.1</td>
</tr>
<tr>
<td>S.</td>
<td>8,061 - 8.4%</td>
<td>6,365 - 57.9</td>
<td>2420 - 42.3</td>
</tr>
<tr>
<td>T.</td>
<td>3,283 - 13.4%</td>
<td>3,640 - 154.2</td>
<td>450 - 450</td>
</tr>
</tbody>
</table>

Figure 6 - Financial Assumptions

$3.5 Million Total Replacement Cost
$3.15 Million Mortgage
7% Interest Rate
125, 15%, 18% investment equity of mortgage
18 month construction period
$87,000 expense for land
$340,000 Tax Deduction expense during construction
40 year life
Sum of the Year Digits Depreciation Method.

Investor owns 10% interest in the development

Figure 7 and 8 - Financial Assumptions

$1.5 Million Total Replacement Cost
$1.35 Million Mortgage
7% Interest Rate
12%, 15%, 18% investment equity of mortgage
12 month construction period
$112,000 expense of land
$150,000 Tax Deduction expense during construction
33 year life
Sum of the Year Digits Depreciation Method.

Forebearance of 75% of the Debt Service
Investor owns 10% interest in the development

Figure 9 and 10 - Financial Assumptions

$1,213,444 Total Replacement Cost
$1,092,100 Mortgage
7% Interest Rate
24% investment equity of mortgage
12 month construction period
$152,000 Tax deductible expenses during construction
5 year depreciation period for $835,915
125% declining-balance method of depreciation on $246,675
building shell

Forebearance of 75% of the Debt Service
Investor owns 10% interest in the development
Figure 11 - Financial Assumptions

Same assumptions as in Figure 6 and 7 except:

One investor own 100% of the project
100% mortgage remains
4% investment equity of mortgage
125% of straight line depreciation taken
Conversion to Limited Dividend Project after 2 years of operation.
Figure 6

Investors' Net Unrecovered Investment After Tax on Foreclosure

NEW HIGH RISE APARTMENTS

<table>
<thead>
<tr>
<th>Assumptions Invested in Subject to Tax Preference</th>
<th>Tax Benefits Received to Date of Foreclosure</th>
<th>Net Unrecovered Investment Before Foreclosure</th>
<th>Tax Burden of Unrecovered Investment</th>
<th>Net Unrecovered Investment as a % of Original Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>12% Investment</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2-year foreclosure</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>50% tax bracket</td>
<td>$37,800</td>
<td>$11,821</td>
<td>$5,979</td>
<td>$13,103</td>
</tr>
<tr>
<td>60% tax bracket</td>
<td>37,800</td>
<td>36,505</td>
<td>(7,389)</td>
<td>16,075</td>
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<tr>
<td>70% tax bracket</td>
<td>37,800</td>
<td>45,189</td>
<td>(7,389)</td>
<td>16,075</td>
</tr>
<tr>
<td>5-year foreclosure</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>50% tax bracket</td>
<td>37,800</td>
<td>46,232</td>
<td>(8,432)</td>
<td>26,575</td>
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<tr>
<td>60% tax bracket</td>
<td>37,800</td>
<td>56,164</td>
<td>(18,364)</td>
<td>28,533</td>
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<tr>
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<td>37,800</td>
<td>66,097</td>
<td>(28,297)</td>
<td>30,492</td>
</tr>
<tr>
<td>8-year foreclosure</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>50% tax bracket</td>
<td>37,800</td>
<td>58,715</td>
<td>(20,915)</td>
<td>36,840</td>
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<tr>
<td>60% tax bracket</td>
<td>37,800</td>
<td>71,444</td>
<td>(33,644)</td>
<td>37,876</td>
</tr>
<tr>
<td>70% tax bracket</td>
<td>37,800</td>
<td>84,174</td>
<td>(46,374)</td>
<td>38,913</td>
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<tr>
<td>18% Investment</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>2-year foreclosure</td>
<td></td>
<td></td>
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<tr>
<td>50% tax bracket</td>
<td>47,250</td>
<td>32,282</td>
<td>14,968</td>
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<td>47,250</td>
<td>39,068</td>
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<td>47,271</td>
<td>(21)</td>
<td>23,771</td>
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<td>57,633</td>
<td>(18,133)</td>
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<td>(20,364)</td>
<td>27,800</td>
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<td>8-year foreclosure</td>
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<td>(39,191)</td>
<td>36,560</td>
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<tr>
<td>18% Investment</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2-year foreclosure</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>50% tax bracket</td>
<td>56,700</td>
<td>32,744</td>
<td>23,956</td>
<td>6,091</td>
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<tr>
<td>60% tax bracket</td>
<td>56,700</td>
<td>39,631</td>
<td>17,069</td>
<td>7,309</td>
</tr>
<tr>
<td>70% tax bracket</td>
<td>56,700</td>
<td>44,520</td>
<td>10,190</td>
<td>8,528</td>
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<tr>
<td>5-year foreclosure</td>
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<td></td>
</tr>
<tr>
<td>50% tax bracket</td>
<td>56,700</td>
<td>48,310</td>
<td>8,380</td>
<td>20,967</td>
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<tr>
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<td>56,700</td>
<td>58,703</td>
<td>(2,003)</td>
<td>23,045</td>
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<tr>
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<td>56,700</td>
<td>69,095</td>
<td>(12,395)</td>
<td>25,124</td>
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<td>8-year foreclosure</td>
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<td></td>
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<tr>
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<td>56,700</td>
<td>61,868</td>
<td>(5,168)</td>
<td>32,109</td>
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<td>56,700</td>
<td>75,293</td>
<td>(18,593)</td>
<td>33,209</td>
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<tr>
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<td>56,700</td>
<td>88,714</td>
<td>(32,014)</td>
<td>34,308</td>
</tr>
</tbody>
</table>
Figure 7

Net Benefits to Investor of Remaining in Project Under 2-Year Forbearance as Opposed to Being Foreclosed

NEW GARDEN APARTMENTS

<table>
<thead>
<tr>
<th>ACCRUAL BASIS</th>
<th>12% Investment</th>
<th>15% Investment</th>
<th>18% Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Assuming Forbearance Policy</td>
<td>Tax Burden if Project is Foreclosed</td>
<td>Net Benefit of Remaining in Project</td>
</tr>
<tr>
<td></td>
<td>Benefit of Future Operating Tax Losses</td>
<td>Gain on Final Disposition</td>
<td>Benefit Less Burden</td>
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<tr>
<td>2-year assignment</td>
<td>$21,855, 10,352, 11,503</td>
<td>$5,680, 17,183</td>
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<td>5% tax bracket</td>
<td>26,643, 10,352, 16,291</td>
<td>6,346, 22,637</td>
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</tr>
<tr>
<td>5% tax bracket</td>
<td>31,430, 10,352, 21,078</td>
<td>7,011, 28,069</td>
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</tr>
<tr>
<td>5-year assignment</td>
<td>$16,665, 11,869, 4,796</td>
<td>$12,451, 17,247</td>
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<tr>
<td>5% tax bracket</td>
<td>20,276, 11,869, 8,407</td>
<td>13,399, 21,798</td>
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<tr>
<td>5% tax bracket</td>
<td>23,894, 11,869, 12,025</td>
<td>14,330, 26,355</td>
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</tr>
<tr>
<td>8-year assignment</td>
<td>$11,804, 13,657, (1,853)</td>
<td>$17,549, 15,696</td>
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<tr>
<td>5% tax bracket</td>
<td>14,335, 13,657, 678</td>
<td>18,086, 18,764</td>
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</tr>
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<td>5% tax bracket</td>
<td>16,869, 13,657, 3,212</td>
<td>18,623, 21,835</td>
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<tr>
<td>5-year assignment</td>
<td>$19,163, 10,732, 8,431</td>
<td>$4,351, 12,982</td>
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<tr>
<td>5% tax bracket</td>
<td>23,376, 10,732, 12,664</td>
<td>5,234, 17,987</td>
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<tr>
<td>5% tax bracket</td>
<td>27,585, 10,732, 16,823</td>
<td>5,917, 22,780</td>
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</tr>
<tr>
<td>5-year assignment</td>
<td>$13,905, 12,314, 1,591</td>
<td>$11,537, 13,128</td>
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<tr>
<td>5% tax bracket</td>
<td>16,809, 12,314, 4,695</td>
<td>12,301, 16,996</td>
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</tr>
<tr>
<td>5% tax bracket</td>
<td>19,864, 12,314, 7,650</td>
<td>13,445, 21,112</td>
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</tr>
<tr>
<td>6-year assignment</td>
<td>$9,012, 14,173, (5,161)</td>
<td>$16,812, 11,651</td>
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<tr>
<td>5% tax bracket</td>
<td>10,955, 14,173, (3,218)</td>
<td>17,363, 14,165</td>
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<tr>
<td>5% tax bracket</td>
<td>12,901, 14,173, (1,272)</td>
<td>17,914, 16,642</td>
<td></td>
</tr>
</tbody>
</table>

### Investors' Net Unrecovered Investment After Tax on Foreclosure

#### NEW GARDEN APARTMENTS

**Assuming Investor is Subject to Tax Preference Items**

<table>
<thead>
<tr>
<th>Original Cash Investment</th>
<th>Tax Benefits Received to Date of Foreclosure</th>
<th>Net Unrecovered Investment Before Foreclosure</th>
<th>Tax Burden Before Foreclosure</th>
<th>Net Unrecovered Investment After Foreclosure</th>
<th>Unrecovered Net Investment as a % of Original Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>15% Investment</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2-year foreclosure</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>50% tax bracket</td>
<td>16,200</td>
<td>281,674</td>
<td>4,570</td>
<td>2,500</td>
<td>2,000</td>
</tr>
<tr>
<td>60% tax bracket</td>
<td>16,200</td>
<td>16,546</td>
<td>6,346</td>
<td>5,998</td>
<td>37,02</td>
</tr>
<tr>
<td>70% tax bracket</td>
<td>16,200</td>
<td>19,621</td>
<td>7,011</td>
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<td>38,868</td>
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<td>(24.97)</td>
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</tr>
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<td>5,000</td>
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<td>17,363</td>
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<td>20,250</td>
<td>40,355</td>
<td>17,914</td>
<td>(2,166)</td>
<td>(10.70)</td>
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<td>14,824</td>
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<td>22,545</td>
<td>11,024</td>
<td>12,379</td>
<td>50.94</td>
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<td>11,612</td>
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<td>35.09</td>
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<td>32,223</td>
<td>12,600</td>
<td>4,677</td>
<td>19.25</td>
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</tr>
<tr>
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<td>29,181</td>
<td>16,075</td>
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<td>35,487</td>
<td>16,640</td>
<td>5,453</td>
<td>22.64</td>
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<td>70% tax bracket</td>
<td>24,300</td>
<td>41,795</td>
<td>17,205</td>
<td>(290)</td>
<td>(1.19)</td>
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Figure 9

Investors' Net Unrecovered Investment After Tax on Foreclosure

<table>
<thead>
<tr>
<th>Assumption</th>
<th>2-year Foreclosure</th>
<th>3-year Foreclosure</th>
<th>5-year Foreclosure</th>
<th>10-year Foreclosure</th>
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<tbody>
<tr>
<td></td>
<td>50% Tax Bracket</td>
<td>60% Tax Bracket</td>
<td>70% Tax Bracket</td>
<td></td>
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<td>Original Cash Investment</td>
<td>$26,208</td>
<td>$26,208</td>
<td>$26,208</td>
<td>$26,208</td>
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<tr>
<td>Tax Benefits Received</td>
<td>$25,681</td>
<td>$31,512</td>
<td>$37,344</td>
<td>$16,006</td>
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<td>Net Unrecovered Investment Before Foreclosure</td>
<td>$527</td>
<td>$(3,304)</td>
<td>$(11,136)</td>
<td>$(16,533)</td>
</tr>
<tr>
<td>Tax Burden of Foreclosure</td>
<td>$16,006</td>
<td>$19,170</td>
<td>$22,334</td>
<td>$13,866</td>
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<td>Net Unrecovered Investment</td>
<td>$16,533</td>
<td>$13,866</td>
<td>$11,198</td>
<td>$63.08</td>
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<tr>
<td>Unrecorded Net Investment as % of Original Investment</td>
<td>62.00</td>
<td>52.90</td>
<td>42.72</td>
<td></td>
</tr>
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</table>

Figure 10

Net Benefits to Investor of Remaining in Project Under a 2 Year or a Lifetime Forbearance Policy as Opposed to Being Foreclosed

REHABILITATION - SCATTERED SITES

### 1974 INVESTMENT

#### 2-year Forbearance

<table>
<thead>
<tr>
<th>Tax Return</th>
<th>Benefits of Future Operating</th>
<th>Tax Burden of Gain on Final Disposition</th>
<th>Benefit Loss of Being Forclosed in Project</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Accrual</strong></td>
<td></td>
<td></td>
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<td>$16,191</td>
<td>$12,198</td>
<td>$3,993</td>
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<td>20,093</td>
<td>12,198</td>
<td>7,895</td>
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<td>23,986</td>
<td>12,198</td>
<td>11,788</td>
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<td>Cash</td>
<td>15,046</td>
<td>11,412</td>
<td>3,634</td>
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<td>18,742</td>
<td>11,412</td>
<td>7,330</td>
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<td>22,413</td>
<td>11,412</td>
<td>11,001</td>
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<td><strong>Lifetime Forbearance</strong></td>
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<td></td>
<td></td>
</tr>
<tr>
<td><strong>Accrual</strong></td>
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<td></td>
</tr>
<tr>
<td>50% tax bracket</td>
<td>$31,693</td>
<td>20,412</td>
<td>11,281</td>
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<td>38,556</td>
<td>20,412</td>
<td>18,274</td>
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<td>46,517</td>
<td>20,412</td>
<td>26,103</td>
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<tr>
<td><strong>Cash</strong></td>
<td></td>
<td></td>
<td></td>
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<td>50% tax bracket</td>
<td>17,887</td>
<td>12,952</td>
<td>4,935</td>
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<td>22,119</td>
<td>12,952</td>
<td>9,167</td>
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<td>26,350</td>
<td>12,952</td>
<td>13,398</td>
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Figure 11

Anticipated Tax Results to Prospective New Investors in a Non-Profit Section 236 Project Which is Reconstituted as a Limited Dividend Section 236 Project

<table>
<thead>
<tr>
<th></th>
<th>Including Tax Preference Items</th>
<th></th>
<th>Excluding Tax Preference Items</th>
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<tr>
<td></td>
<td>Tax Benefits</td>
<td>Tax Burden</td>
<td>Net Benefit</td>
<td>Tax Benefits</td>
</tr>
<tr>
<td>DISPOSITION IN 1978 (A)</td>
<td></td>
<td></td>
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<tr>
<td>Accrual Basis</td>
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</tr>
<tr>
<td>50% tax bracket</td>
<td>$188,624</td>
<td>$(131,747)</td>
<td>$56,877</td>
<td>$192,109</td>
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<td>227,045</td>
<td>(133,837)</td>
<td>93,208</td>
<td>230,531</td>
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<td>265,470</td>
<td>(135,928)</td>
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<td>268,954</td>
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<td>(66,739)</td>
<td>40,588</td>
<td>110,812</td>
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<td>129,490</td>
<td>(68,829)</td>
<td>60,661</td>
<td>142,977</td>
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<td>70% tax bracket</td>
<td>151,653</td>
<td>(70,920)</td>
<td>80,733</td>
<td>155,137</td>
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<tr>
<td>DISPOSITION IN 1991 (B)</td>
<td></td>
<td></td>
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<td>594,923</td>
<td>(454,808)</td>
<td>140,115</td>
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<td>714,629</td>
<td>(454,808)</td>
<td>259,821</td>
<td>718,269</td>
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<td>(454,808)</td>
<td>379,533</td>
<td>837,959</td>
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<td>(220,779)</td>
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<td>424,736</td>
<td>(220,779)</td>
<td>203,957</td>
<td>428,354</td>
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</tbody>
</table>

(A) Assumes a foreclosure in 1978.

(B) Assumes a final disposition in 1991 for the mortgage amount.

FOOTNOTES

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6 U.S. Housing and Urban Development Report, July 1975

7 "Failed projects make HUD $2.5 Billion owner", Engineering News Review.

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3 Ibid., p 218-221.
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6 Management of HUD Insured Multifamily Projects under Section 221(d) 3 and Section 236 of the National Housing Act, HUD Handbook, Oct., 1974, p. 74.
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5 Ibid.
6 Ibid.
8 Note Information Statement, MHFA, p. C8.

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9 Ibid., pp. 8-13.


11 Management Agreement, MHFA.

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17 The Report of the Pause Committee, MHFA.
18 Management of HUD Insured Multi-family Project, HUD Handbook, p. 120.
19 Ibid.
20 Ibid., p. 124.
21 The Report of the Pause Committee, MHFA.

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4 Personal interview with Keith King.
5 Personal interview with Edward Blackman, Special Assistant, Massachusetts Housing Finance Agency, Boston, Mass., March 18, 1976, Distressed Housing Developments.
6 Ibid.
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3 Ibid.
4 Ibid., p. 84.
5 Ibid.
6 Young, The Role of Motive In Evaluating Tax Sheltered, Tax Lawyer, New York, N.Y., 1969, pp. 57-64
8 Ibid.
9 Treasury Regulation Section 1.446-1(e) (3)(i)
11 Internal Revenue Code, Section 708 (b), 1975.
12 Ibid.
13 Ibid.
14 Lewis Kaster, Subsidized Housing Workouts, pp. 58-72
17 Ibid.
18 Ibid.
19 Young, The Role of Motive In Evaluating Tax Sheltered Investments, pp. 65-70.

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20 Ibid.
21 Ibid.
22 Treasury Regulation Section 1.162-4, 1975.
23 Treasury Regulation 45, Article 7, 1975.
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3 Ibid.

4 Section 8 Housing Assistance Payments Program, HUD, April 1975, pp. 1-1 to 1-4.

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